FCC 1.12/3:4/8

SOCIOLOGY & ECONOMICS
STATE PUBLIC LIBRARY

Volume 4, No. 8, Pages 2778 to 3381,
April 10 - April 21, 1989.

FCC Record

A comprehensive compilation of decisions, reports, public notices and other documents of the Federal Communications Commission of the United States.

FEDERAL COMMUNICATIONS COMMISSION

Dennis R. Patrick, Chairman

James H. Quello

Patricia Diaz Dennis

The contents of this document are subject to correction by means of an erratum appearing at a future date in the FCC Record. Users should notify the Secretary of errors so that an erratum can be inserted in a later publication.

The appropriate citation for documents printed in the FCC Record should include the volume number, page number, and year. See 47 C.F.R. §1.14. Earlier Commission documents may continue to be cited to the FCC Reports.

Citation Form: 4 FCC Rcd 1 (1989)

United States Government Printing Office • Washington, D.C.

For Sale by the Superintendent of Documents, U.S. Government Printing Office
on a subscription basis

Detroit Public Library

JUN 2 1989

Depository Document

Federal Communications Commission Record

Volume 4
Issue 8

Table of Contents

Table of Cases..... i

Table of FCC and Delegated Authority Numbers..... ii

Table of Docket Numbers..... iii

Table of Localities..... iv

Table by Subject Matter..... v

Table by Statutory and Rule Provisions..... vii

Decisions, Reports, Memorandum Opinions, Orders, and
Other Selected Material.....2778

Federal Communications Commission Record

Table of Cases
Volume 4
Issue 8

Case Name	Page
Access for 800 Service	2824
Amendment of Part 73 - FM Broadcasting Stations, Class C3	2792
American Telephone and Telegraph Company	2820
Ameritech Operating Companies	2865
Ameritech Operating Companies (ERRATUM)	3381
Coordination of Assignments in the 2500-2686 MHZ Band	2866
Established Pleading Cycle/Petition for Declaratory Ruling	2823
Kramer, Renee Marie	2848
Message Center, Inc.	2821
Nirvana Radio Broadcasting Corporation	2778
Pay Telephone Presubscription	2782
Policy and Rules Concerning Rates for Dominant Carriers	2873
Policy and Rules Concerning Rates for Dominant Carriers (ERRATUM)	3379
Revisions to the Average Schedules Proposed by NECA	2804
Tucker, Ted and Jana	2816
University of North Carolina	2780

Federal Communications Commission Record

Table of Cases by Delegated Authority and FCC Number
Volume 4
Issue 8

Delegated Authority or FCC Number	Page
DA 89 - 244	2782
DA 89 - 353	2804
DA 89 - 411	2866
DA 89 - 431	2820
DA 89 - 433	2821
DA 89 - 435	2823
DA 89 - 436	2865
DA 89 - 455	3379
DA 89 - 479	3381
FCC 89 - 91	2873
FCC 89 - 92	2816
FCC 89 - 99	2780
FCC 89 - 106	2824
FCC 89 - 107	2792
FCC 89D - 15	2848
FCC 89R - 25	2778

Federal Communications Commission Record

Table of Cases by Docket Number
Volume 4
Issue 8

Docket Number				Page
CC	Dkt.No.86	-	10	2824
CC	Dkt.No.87	-	313	2873
CC	Dkt.No.87	-	313	3379
MM	Dkt.No.87	-	288	2778
MM	Dkt.No.87	-	532	2848
MM	Dkt.No.88	-	375	2792

Table of Cases by City
Volume 4
Issue 8

City/State	Page
Bradenton, FL	2848
Burlington, VT	2821
Chapel Hill, NC	2780
Christiansburg, VA	2778
San Manuel, AZ	2816

Federal Communications Commission Record

Subject Index
Volume 4
Issue 8

Subject	Page
Adjudication	
Air hazard	2848
Authority delegated	2848
Declaratory ruling	2848
Limited partnership	2848
Orders or Notices	
Programming, deceptive	2848
Reconsideration, timeliness and	2848
Review Board or Commission Decision	
Reopening of record	2848
Broadcast Radio Services - General Rules	
Records kept by stations	
Equal employment opportunity program	2780
Broadcasting - FM Stations	
Allotments and assignments	
Distances between stations, minimum	2792
Technical requirements	
Antenna height and power requirements	2792
Broadcasting - Noncommercial Educational FM	
Allocations and assignments	
Channels and stations, classification of	2792
Carriers: Service Altered	
Extensions and supplements	
Applications, contents of	2820
Communications Act of 1934	
Common Carriers	
Extension of lines, certificate for	2820
Service and charges	2824
Radio, provisions relating to	
Construction permits	2816
Practice and Procedure	
Common carriers: applications under Title II Act	
Licenses, cable landing	2820
Common carriers: tariffs	
Filing, petitions related to new	2782
Reconsideration/review of Commission action	

Subject	Page
Reconsideration of a final FCC action, petition for	2816
Rulemaking proceedings: proceedings	
FM/television/air-ground table of assignments, comments filed re	2792

TABLE OF STATUTORY AND RULE PROVISIONS

	Page
001.106 petitions for reconsideration	2816
001.420 Additional procedures in proceedings for amendment o	2792
001.767, Cable Landing License	2820
022.023 Amendment of applications	2821
047.000 C.F.R. 0.451	2823
047.000 C.F.R. § 1.773	2782
047.000 C.F.R. §69.606, Computation of Average Schedule Com	2804
063.001, Contents of Application	2820
069.001 Application of access charges	2824
073.207 Minimum distance separation between stations.	2792
073.2080 Equal Employment Opportunity	2780
073.210 Station classes.	2792
073.211 Power and antenna height requirements.	2792
073.3525 Settlement Agreement, Conditionally Approved	2778
073.3573 Processing of FM broadcast and FM translator appli	2816
073.506 Classes of noncommercial educational FM stations and	2792
074.1235 Power limitations	2816
300:201, Service and charges	2824
300.214, Disc. of Lines	2820
300.319 Construction permits	2816
300.634 Equal Employment Opportunity	2780
500.005 - Integration, Qualitative	2848
500.025 - Integration, local residence	2848
500.035 - Integration, Quantitative	2848
500.045 - Diversification, Quantitative	2848
500.095 - Character qualifications	2848
500.125 - Misrepresentation and lack of candor	2848
500.135 - Real party in interest	2848
500.145 - Air Hazard Issues	2848
500.220 - Limited partnership	2848
Part 21, Domestic Public Fixed Radio Services	2866
Part 74, Experimental, Auxiliary, and Special Broadcast and	2866
Part 94, Private Operational-Fixed Microwave Service	2866
Sec. 0.291 authority delegated	2865
Sec. 204(a) lawfulness of new charges; suspension	2865

Before the
Federal Communications Commission
Washington, D.C. 20554

MM Docket No. 87-288

In re Applications of

NIRVANA RADIO BROADCASTING CORPORATION — File No. BPH-860203MH

VALLEY RADIO CORPORATION — File No. BPH-860203PC

For Construction Permit for a New FM Station on Channel 264 in Christiansburg, Virginia

MEMORANDUM OPINION AND ORDER

Adopted: April 13, 1989; Released: April 21, 1989

By the Review Board: MARINO (Chairman), BLUMENTHAL, and ESBENSEN.

1. On March 7, 1989, the two applicants in this case, Nirvana Radio Broadcasting Corporation (Nirvana) and Valley Radio Corporation (Valley), filed a Joint Request for Approval of Agreement with the Review Board. The Board was asked to defer action on the joint request until the Mass Media Bureau acted on a related case involving the renewal license of Station WFNR (AM), Blacksburg, Virginia. Robert T.S. Colby, the 100% stockholder of Valley, is also the 100% stockholder of New River Broadcasting Corporation, the licensee of WFNR. On March 22, 1989, the Bureau filed comments supporting the settlement agreement in our Christiansburg case, and on April 5, 1989, the Bureau granted the Blacksburg application. *See* letter from Chief, AM Branch, Audio Services Division, Mass Media Bureau to Barry A. Friedman, Esquire, 8910-SJC, dated April 5, 1989. The Board is now in a position to act on the joint request, which will be conditionally approved for the reasons set out below.

2. Administrative Law Judge Edward J. Kuhlmann issued an *Initial Decision*, 3 FCC Rcd 6038 (released October 14, 1988) in the above-captioned proceeding, in which he found both applicants qualified to be Commission licensees. He granted Valley's application, however, after concluding that it was the comparatively superior applicant. This proceeding came before the Review Board on exceptions filed by the parties, and oral argument was held on February 3, 1989. After oral argument, Valley reached a settlement agreement with Nirvana and its president and stockholder, Kenneth R. Strawberry, who is also a limited partner of the applicant involved in the Blacksburg matter referred to above. Under the agreement, the Nirvana-Christiansburg and Strawberry-Blacksburg applications would be dismissed, and both Nirvana and Strawberry would execute a covenant not to compete in Christiansburg and Blacksburg. In return, Valley would provide to Nirvana monetary consideration, totalling $102,500.

3. In the Blacksburg proceeding, as noted above, the Bureau has now acted, dismissing the Strawberry-related application for a new AM station, and granting the renewal of Station WFNR(AM). With the Bureau's resolution of the Blacksburg case, the only question remaining is whether the Joint Request for Approval of Agreement in our Christiansburg case complies with the requirement of the Commission's Rules, 47 CFR §73.3525(a).

4. In general, Nirvana and Valley have shown that approval of their proposed settlement will serve the public interest by ending their litigation and expediting a new service for the community of Christiansburg. Moreover, each applicant has also formally declared that its application was not filed for purposes of reaching a settlement. Thus, in most respects, the agreement complies with the requirements of 47 CFR §73.3525, and is grantable with one reservation.

5. Our sole area of concern relates to the covenant not to compete, which provides that Nirvana and Strawberry would not, for a period of five years:

> (a) become, remain engaged in, or have any ownership in, or participate, directly or indirectly, in the management of, or consult on behalf of, any radio station licensed by the Federal Communications Commission to Blacksburg or Christiansburg, Virginia,
>
> (b) induce or attempt to induce any employee of the stations to terminate his employment or any advertiser to terminate its business dealings with the stations, or
>
> (c) file any application, complaint, petition to deny, informal objection, or other document of any nature or kind with the FCC that competes with, objects to, or challenges the construction permit or licenses of the stations, any assignments or transfers of control of the construction permit or licenses of the stations, any applications to modify the construction permit or licenses of the stations or any other formal or informal application or request to the FCC filed by the stations.

The covenant not to compete would expire sooner were Colby to sever his relationship with either the Christiansburg or Blacksburg facilities before the five year period was up. In that case, the covenant would terminate six months after Colby left.

6. Historically, the Commission has disfavored covenants not to compete, concluding that:

> it is contrary to the public interest for participants in a proceeding to preclude by a private agreement the future filing of applications which might involve improvement in service to the public . . . .

James S. Rivers, Inc., 26 FCC 4 (1959). *See also Seven Hills Television Co.*, 2 FCC Rcd 6867, 6890 (Rev. Bd. 1987) (subsequent history omitted). Hence, general covenants not to compete have repeatedly been disapproved. *See, e.g., Central Coast Broadcasters, Inc.*, 29 FCC 2d 465

(1971); *Dayton Telecasting, Inc.*, 96 FCC 2d 214 (Rev. Bd. 1983); *Viking Television, Inc.*, 16 RR 2d 862 (Rev. Bd. 1969); *Augusta Telecasters, Inc.*, 10 FCC 2d 594 (Rev. Bd. 1967); *Romac Baton Rouge Corp.*, 8 FCC 2d 304 (Rev. Bd. 1967); *North Atlanta Broadcasting Co.*, 25 RR 715 (Rev. Bd. 1963). An exception to this policy, however, was recognized early on with respect to covenants not to compete in station sales agreements, when the restrictions were "ancillary" to the "main purpose of a lawful contract," and "reasonably limited as to duration and geography." *Raul Santiago Roman*, 38 FCC 290, 294-295 (Rev. Bd. 1965).

7. In 1985, however, the Commission slightly loosened the strictures of *James S. Rivers, Inc.* (albeit in a comparative renewal case), and approved a covenant not to compete which barred the dismissing applicants and their principals from "'turning right around' and beginning a new comparative renewal proceeding." *Intercontinental Radio, Inc.*, 62 RR 2d 1565, 1567 (1985). More particularly, that covenant, as modified, prohibited the dismissing parties from pursuing the right to apply to construct a station on the same frequency as the grantee until the end of the license term following the current term. And thereafter, in *James U. Steele*, FCC 88I-089, released September 7, 1988, a construction permit proceeding for a new FM station in St. Simons Island, Georgia, the Commission further relaxed the *Rivers* constraints, and gave its stamp of approval, subject to a time limitation, to a general covenant not to compete, which covenant prohibited the dismissing applicant from acquiring an interest in any broadcast facility, the transmitter of which would be located within 25 miles of St. Simons Island. The Commission stated that the covenant was reasonably limited in geographic scope, but directed the parties to reform their agreement so that it would expire at the end of the first full license term after approval of the settlement agreement.

8. Consistent with the precedent above, we conclude that clauses (a) and (b) of the agreement are acceptable because they are reasonably limited in duration and geographic scope. *See James U. Steele, supra.* That is, the covenant restricts the dismissing applicants, and Strawberry, from competing with the Christiansburg and Blacksburg stations for, at most, five years, a duration substantially less than the full license term countenanced in *Steele* (*see* 47 CFR §73.1020(a) -- radio broadcasting station ordinarily renewed for 7 years), and is limited in geographic extent to Christiansburg and Blacksburg, Virginia.

9. Clause (c) of the agreement, however, which, in essence, proscribes the filing of any submission with the Commission that might jeopardize the Christiansburg and Blacksburg facilities, is too inclusive, and cannot be approved as currently worded, insofar as it prevents the dismissing parties from bringing to the Commission's attention any matter, however substantial, even when those parties have a *bona fide* belief that the stations are not being operated in the public interest. Although a provision prohibiting the filing of applications for broadcast facilities in the subject communities for the prescribed period of time would raise no similar objections, *see Steele, supra,* the remaining prohibited filings in clause (c), so far as such submissions were filed in good faith, are restrictions with "potential public interest detriment." *Intercontinental Radio, Inc.*, 62 RR 2d at 1568. In this regard, however, we note that the agreement provides that the covenants contained therein are severable. *See* para. 7 of Agreement. We will, therefore, approve the settlement agreement, subject to the condition that clause (c) is reformed consistent with our discussion above.

10. ACCORDINGLY, IT IS ORDERED, That the Joint Request for Approval of Agreement, filed March 7, 1989 by Valley Radio Corporation and Nirvana Radio Broadcasting Corporation IS GRANTED, and the attached settlement agreement IS APPROVED, subject to the condition that the parties notify the Review Board within 15 days from the release date of this opinion that clause (c) of para. 1 of the covenant not to compete has been modified consistent with our discussion in para. 9, above.

11. IT IS FURTHER ORDERED, That the exceptions of the parties ARE DISMISSED; that the application of Nirvana Radio Broadcasting Corporation IS DISMISSED; that the application of Valley Radio Corporation (File No. BPH- 860203PC) IS GRANTED, subject to the condition noted in para. 10, above, and the special operating condition imposed on Valley's Christiansburg facility by para. 15 of the *Initial Decision*, 3 FCC Rcd 6038, 6040; and that this proceeding IS TERMINATED.

FEDERAL COMMUNICATIONS COMMISSION

Joseph A. Marino
Chairman, Review Board

Before the
Federal Communications Commission
Washington, D.C. 20554

In re Application of

UNIVERSITY OF	File Nos. BRET-860804 KF
NORTH CAROLINA	BRET-860804 KG
For Renewal of License of	BRET-860804 KH
Station WUNC-TV *et al.*	BRET-860804 KI
Chapel Hill, North Carolina	BRET-860804 KJ
	BRET-860804 KK
	BRET-860804 KL
	BRET-860804 KM
	BRET-860804 KN

MEMORANDUM OPINION AND ORDER

Adopted: March 27, 1989; Released: April 10, 1989

BY THE COMMISSION:

1. The Commission has before it for consideration: (i) a "Petition for Reconsideration" filed May 4, 1988 by the National Black Media Coalition and the North Carolina State Conference of Branches of the NAACP (hereinafter the "petitioners" or "NBMC/NAACP")[1] pursuant to Section 1.106 of the Commission's Rules, (ii) an opposition pleading filed by the licensee; (iii) the petitioner's reply; and (iv) a related pleading.[2] NBMC/NAACP seek reconsideration of our Memorandum Opinion and Order (Order) in *Catawba Valley Broadcasting Co., Inc.*, 3 FCC Rcd 1913 (1988), wherein we granted, *inter alia*, renewal of license, subject to reporting conditions, to the University of North Carolina for nine stations serving communities in the State of North Carolina.[3]

2. *Procedural Matters*. The licensee argues that the NAACP lacks standing to petition this Commission pursuant to Section 405 of the Act and Section 1.106 of the rules. The licensee maintains that: (1) the NAACP is not a party in interest because the NAACP was not a party to the earlier proceeding initiated by NBMC's informal objection; (2) the NAACP does not demonstrate that its interests are adversely affected by the Commission's decision to grant the renewal applications; and (3) the NAACP does not demonstrate good cause for not participating in the earlier stages of this proceeding. The NAACP insists, however, that because the *Order* failed to address clear factual discrepancy, the NAACP must enter this proceeding in order to ensure protection of its members' rights. The NAACP maintains that, based on its review of the evidence and the Commission's decision, the Commission will not scrutinize the licensee as closely during the upcoming license term as the evidence warrants. Lastly, NAACP contends that the licensee is not prejudiced by the NAACP's petition for reconsideration because NBMC's informal objection gave the licensee adequate notice of the EEO issues of concern to the NAACP.

3. Section 405 of the Act states that any party to an order, decision, report or action by the Commission or any other person aggrieved or whose interests are adversely affected may petition for reconsideration. 47 U.S.C. Section 405; 47 C.F.R. Section 1.106; *Committee for Community Access v. FCC*, 737 F.2d 74 (D.C. Cir. 1984). To qualify as a party, a petitioner for reconsideration must have filed a valid petition to deny against the application whose grant the petitioner now seeks to have reconsidered. *Community Access, supra; Montgomery County Broadcasting Corporation*, 65 FCC 2d 876 (1977). If the petition for reconsideration is filed by one who is not a "party to the proceeding, it shall state with particularity the manner in which the person's interests are adversely affected by the action taken, and shall show good reason why it was not possible for him to participate in the earlier stages of the proceeding." 47 C.F.R. Section 1.106 (b)(1); *Community Access, supra*.

4. The only pre-grant pleading filed by either of the petitioners was an informal objection filed by NBMC. As Commission precedent makes clear, such a pleading does not confer party status on the informal objector within the meaning of Section 405 of the Communications Act and Section 1.106 of our rules. *Montgomery County, supra* at 877. Also, NBMC has not shown that it was adversely affected by the decision and that there was a good reason why it could not participate in the earlier stages of the proceeding as a party. Accordingly, we conclude that NBMC lacks standing to bring the instant petition and, in any event, has not complied with the procedural requirements of Section 1.106.

5. Next, as stated above, the NAACP was not a party to the earlier stages of the proceeding. Review of the statement under penalty of perjury submitted by Kelly M. Alexander, Jr. for the NAACP indicates that the NAACP and its members filed the petition because it would be seriously aggrieved unless the station institutes proper employment practices and presents responsible programming. The statement, however, fails to indicate why it was not possible for the NAACP and its members to participate in the earlier stages of the proceedings. Notwithstanding whether the NAACP and its members will be adversely affected and would therefore have standing, it has not justified its failure to participate in the earlier proceedings. Accordingly, we conclude that the NAACP has failed to meet the Section 1.106 requirements for filing a petition for reconsideration.

6. Accordingly, IT IS ORDERED, That the petition for reconsideration filed May 4, 1988 by NBMC/NAACP, IS DISMISSED.

7. IT IS FURTHER ORDERED, That the Secretary of the Commission send by Certified Mail - Return Receipt Requested one copy of this Memorandum Opinion and Order to NBMC, the North Carolina Conference of the NAACP and the University of North Carolina.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

FOOTNOTES

[1] The National Black Media Coalition (NBMC), headquartered in Washington, D.C., is a national association of Black organizations and persons seeking additional Black employment, program service and ownership in the media. The petition was filed jointly by NBMC and the North Carolina State Conference of Branches of the National Association for the Advancement of Colored People (NAACP).

[2] The NAACP filed a statement under penalty of perjury from Kelly M. Alexander, Jr., President of the North Carolina Conference of Branches of the NAACP.

[3] The University of North Carolina is licensee of nine public television stations in North Carolina: WUNC-TV, Chapel Hill; WUND-TV, Columbia; WUNE-TV, Linville; WUNF-TV, Asheville; WUNG-TV, Concord; WUNJ-TV, Wilmington; WUNK-TV, Greenville; WUNL-TV, Winston-Salem; and WUNM-TV, Jacksonville. The licensee files a consolidated report for these nine stations which comprise the University of North Carolina Center for Public Television.

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

PAY TELEPHONE PRESUBSCRIPTION

The Bell Atlantic Telephone Companies Tariff F.C.C. No. 1	Transmittal No. 276
The BellSouth Telephone Companies Tariff F.C.C. No. 1	Transmittal No. 204
Southwestern Bell Telephone Company Tariff F.C.C. No. 68	Transmittal No. 1742
New York Telephone Company Tariff F.C.C. No. 41	Transmittal No. 947
New England Telephone Company Tariff F.C.C. No. 40	Transmittal No. 960
The Ameritech Operating Companies Tariff F.C.C. No. 2	Transmittal No. 251
The Pacific Bell Telephone Company Tariff F.C.C. No. 128	Transmittal Nos. 1391 and 1401
The Nevada Bell Telephone Company Tariff F.C.C. No. 1	Transmittal Nos. 73 and 79

ORDER

Adopted: February 27, 1989; Released: February 28, 1989

By the Chief, Common Carrier Bureau:

I. INTRODUCTION

1. Most public and semi-public pay telephone traffic from Bell Operating Company (BOC) payphones is currently routed to American Telephone and Telegraph Company (AT&T).[1] To enable other interexchange carriers (ICs) to enter the BOC payphone market, the United States District Court for the District of Columbia issued an Order which established guidelines for implementation of pay telephone presubscription. That Order required, among other things, that the Bell Operating Companies (BOCs) issue ballots implementing payphone presubscription not later than January 1, 1989.[2] The Court directed the BOCs to base their presubscription procedures on the Commission's *Allocation Order* for business and residential customers.[3] The Bell Atlantic Telephone Companies (Bell Atlantic), the BellSouth Telephone Companies (BellSouth), Southwestern Bell Telephone Company (SWB), New York Telephone Company (New York), New England Telephone Company (New England), the Ameritech Operating Companies (Ameritech), the Pacific Bell Telephone Company (Pacific), and the Nevada Bell Telephone Company (Nevada) have each filed tariffs implementing presubscription balloting and allocation of ICs for pay telephones.[4] These payphone tariffs are scheduled to become effective on March 1, 1989.

2. By this Memorandum Opinion and Order, the Common Carrier Bureau rejects all of the above-mentioned tariffs, except for those of BellSouth and SWB.

II. BACKGROUND AND PLEADINGS

A. *Bell Atlantic*

1. In General

3. Bell Atlantic submits that to be eligible for "Coin Presubscription and Allocation," interexchange carriers must (1) comply with all applicable federal, state, and local regulations; (2) accept and validate the Bell Atlantic calling card on 0+ dialed interLATA calls from Bell Atlantic public telephones; and (3) provide continuous operator services, including interexchange emergency calls and assistance to the handicapped. Bell Atlantic states that calls should be answered, on average, within five seconds, and asserts that the interexchange carrier must identify itself at the beginning of each call and provide charges and rates upon request. Bell Atlantic Description and Justification (D&J) at 2-1 to 2-2.

4. In addition to the criteria detailed above, Bell Atlantic requires that interexchange carriers participating in payphone allocation, among other things, must not charge end users rates "exceeding the highest rates tariffed by a dominant interexchange carrier for comparable calls without the affected end user's consent," and must maintain quality at least equal to the quality of service provided from public telephones on other premises they serve. *Id.* at 2-2 to 2-3. Bell Atlantic states that interexchange carriers may be required to provide announcements specifying the rates charged for certain calls in response to subscriber or regulatory complaint. *Id.* at 2-3.

2. Contentions of the Parties

5. AT&T filed a petition to suspend and investigate Bell Atlantic Transmittal 276 on November 30, 1988. Also on November 30, MCI Telecommunications Corporation (MCI) and US Sprint Communications Company (Sprint) filed petitions to reject or suspend and investigate Transmittal 276. Bell Atlantic replied on December 12.[5]

6. AT&T argues that Bell Atlantic's calling card requirement and pricing limitation are outside the scope of Bell Atlantic's role as the provider of access and create unnecessary and unwarranted barriers to the provision of equal access. AT&T Petition at 2-3. It asserts that Bell Atlantic's calling card requirement is an impermissible bundling of

tariffed equal access services with unregulated, untariffed billing services and has no relation to the tariffed provision of access services. *Id.* at 4. AT&T further argues that the requirement that participating ICs limit their rates to those of the "dominant" IC would create arbitrary price ceilings and would be "an unwarranted intrusion into the competitive interexchange market" by a carrier which has no interest in overseeing ICs' rates. *Id.* at 5-6. Due to the advent of competition in the long distance industry, AT&T submits, no "dominant" IC exists. *Id.* at 5 n.**. In addition, AT&T contends that the minimum service quality standards proposed by Bell Atlantic are unduly stringent and do not relate to the provision of access service, particularly the requirement that ICs answer operator-assisted calls within five seconds. *Id.* at 6-7. It doubts Bell Atlantic's claim that such restrictions are necessary to protect Bell Atlantic's reputation, since the IC will be identifying itself to the end user. *Id.* at 6 n.*.

7. MCI similarly contends that Transmittal 276 is an attempt to bundle calling card service with the balloting and allocation of payphones. MCI Petition at 1-2.[6] MCI further objects to Bell Atlantic's requirement that participating ICs answer operator-assisted calls within five seconds. MCI notes that it placed several test calls from Bell Atlantic payphones and that the Bell Atlantic operator took 10 seconds to answer the call. *Id.* at 3. MCI contends that, not only does Bell Atlantic require performance beyond that which it provides, it has no authority to impose such a restriction of interstate telecommunications services. *Id.* MCI submits that if Bell Atlantic wishes to change any of the requirements of the *Allocation Order*, it should request that the Commission institute a Rule Making. *Id.* at 4.

8. Sprint also contends that Bell Atlantic has exceeded its authority. Sprint asserts that Bell Atlantic does not adequately explain what it means by "emergency call handling." Sprint Petition at 2. Sprint deems it unlikely that callers seeking emergency assistance would contact the IC, and notes that the United States Department of Justice has proposed to allow the BOCs to complete interLATA 911 calls. *Id.* & n.1 (citing Motion of the United States for a Waiver of the Modification of Final Judgment To Permit the BOCs To Provide MultiLATA 911 Service, D. D.C., C.A. No. 92-0192, filed Nov. 17, 1988). Similarly, Sprint argues that because Bell Atlantic fails to define "assistance to the handicapped," interested ICs cannot assess the costs and benefits of providing such services. *Id.* at 3.

9. In addition, Sprint contends that Bell Atlantic is not the proper arbiter of the ICs' appropriate response time. *Id.* at 3-4. Sprint further argues that the IC should not have to identify itself at the beginning of each call, since such identification is not standard industry practice and since many credit card calls can be processed automatically without a prerecorded computer announcement identifying the presubscribed carrier. *Id.* at 5. In addition, Sprint argues that Bell Atlantic's identification requirement is superfluous, since the *October 14 Order* requires the BOCs to identify the presubscribed IC on their pay telephones. *Id.* Sprint also objects to the requirement that it provide rate announcements. *Id.* at 5-6.

10. Bell Atlantic responds that the criteria it has proposed are reasonable. Bell Atlantic submits that all Bell Atlantic payphones display its logo and list its subsidiaries, and it observes that no petitioner claims that the petitioner cannot satisfy the challenged requirements. Bell Atlantic Reply at 1-2. Bell Atlantic argues that its limitation of prices to the highest rates charged by a dominant carrier was mandated by the Commission for business and residential presubscription. *Id.* at 2 (citing *Allocation Order*, 101 FCC 2d at 934). Bell Atlantic also notes that the price limitation is not a prerequisite to a carrier's inclusion on the ballot, but is a condition for participation in the allocation process. *Id.* at n.3.

11. In addition, Bell Atlantic submits that callers should be able to expect that their Bell Atlantic calling cards will be accepted at Bell Atlantic payphones, and notes that AT&T already honors the Bell Atlantic calling card and that MCI has announced plans to do so. *Id.* at 3. Bell Atlantic also maintains that the operator service criteria it specifies will curb end user complaints, which it contends will most likely be directed at Bell Atlantic. *Id.* Bell Atlantic adds that the identification requirement is one of the standards promulgated by the Operator Service Providers of America, and notes that Bell Atlantic and AT&T meet this standard. *Id.* at 3-4. Bell Atlantic contends that end users have the right to know which carriers the end users are using, and argues that instruction placards placed on payphones could be removed or defaced. *Id.* at 4 & n.9. Bell Atlantic similarly defends rate announcements as protecting end users from the exorbitant charges imposed by some companies. *Id.* at 4-5.

12. Bell Atlantic further explains that its requirement that carriers be equipped to handle emergency calls mandates that carriers be able to complete calls to emergency locations such as hospitals and police stations or to transfer such calls to the BOC operator. *Id.* at 5. Bell Atlantic also states that its assistance to the handicapped requirement means helping a disabled person place a call. *Id.* In addition, Bell Atlantic asserts that its five-second response time is based on that of the pre-divestiture Bell System and that which Bell Atlantic imposes upon itself. *Id.* at 5-6. Bell Atlantic notes that the 10-second response time recorded by MCI represents total call setup time, not the response time for the total operator system, which is the subject of the five-second requirement. *Id.* at 6 n.16.

B. *BellSouth*

1. In General

13. BellSouth introduces "preselection" into its payphone plan to denote the period of time during which compliance with the court's Order does not permit observance of IC notification requirements stated in the Commission's *Allocation Order*.[7] BellSouth states that preselection, a retroactive balloting and allocation procedure, applies to public and semi-public pay telephones served by end offices converted to equal access on or before March 31, 1989. BellSouth D&J at 2. BellSouth avers that other public and semi-public pay telephones will be included in its ongoing implementation schedule for equal access conversion. *Id.*

2. Contentions of the Parties

14. On December 7, 1988, International Telecharge, Inc. (ITI) filed a petition to reject or suspend and investigate BellSouth Transmittal 204. MCI filed a petition to suspend and investigate Transmittal 204 on December 8. BellSouth replied on December 19.[8]

15. MCI argues that the BellSouth presubscription plan is contrary to the *Allocation Order* in that it does not provide for 90 days between balloting and conversion of the end office but proposes to implement its plan on February 1, 1989, rather than April 1, 1989. MCI Petition at 3-4. MCI contends that the 90-day waiting period would allow carriers adequately to market their services to premises owners and submits that BellSouth's expedited implementation would unfairly favor AT&T. *Id.* at 3-4. MCI further objects to BellSouth's distinguishing between "preselection" and "presubscription" as unsupported by the *Allocation Order*. *Id.* at n.11.

16. ITI argues that BellSouth fails to include in its tariff all of the relevant practices and regulations it included in the version of its plan filed with the court. ITI Petition at 5-7. Basing its contentions on the plan filed with the court, ITI deems unlawful the requirement that participating ICs obtain state certification to carry intrastate traffic. *Id.* at 7-8. ITI argues that the state certification requirement would benefit AT&T at the expense of smaller carriers like itself, and that the requirement is not included in the *Allocation Order*. *Id.* at 9.

17. ITI further contends that the BellSouth plan to limit participants' rates to those of the "dominant" carrier is unlawful, since charges assessed by non-dominant ICs are presumptively lawful. *Id.* at 10. ITI notes that supporters of this requirement have argued that it is justified by an erratum to the *Allocation Order* which states that non-dominant carriers receiving interexchange traffic through allocation could not charge rates for services which exceeded those charged "by a dominant interexchange carrier for MTS-type service without the customer's consent." *Id.* at 11 (citing Investigation of Access and Divestiture Related Tariffs, CC Docket No. 83-1145, Phase I, Erratum to June 12, 1985, Memorandum Opinion and Order, Mimeo No. 5337, released June 24, 1985). ITI contends, however, that the language of that erratum refers to allocated customers, not presubscribed customers. *Id.* at 11-12. ITI asserts that such a rate restriction would alter the Commission's rules regarding the rates of non-dominant carriers and thus should only be considered via a Rule Making proceeding. *Id.* at 11, 12. In addition, ITI asserts that a carrier's rates may not be arbitrarily tied to those of another carrier. *Id.* at 13 (citing *Aetna Insurance Co. v. Hyde*, 275 U.S. 440, 447 (1928)).

18. ITI further submits that only a few ICs are able to terminate collect international calls. *Id.* at 13-14. In addition, ITI objects to the restriction that participating ICs cannot share information regarding premises owners' names and addresses with outside marketing staff. *Id.* at 14. ITI contends that this restriction limits the marketing efforts of ITI and other smaller non-dominant ICs. *Id.* ITI doubts that these data are proprietary since AT&T already has such information due to its monopoly status. *Id.* at 15.

19. BellSouth, in response to ITI, contends that neither the Communications Act nor the Commission's rules require that a carrier include in its tariff every provision related to a service offering. BellSouth Reply at 4-5. In addition, BellSouth asserts that the Commission has recognized the authority of the states to regulate intrastate services of alternative operator services (AOS) providers. *Id.* at 6 (citing Letter from Chairman, Federal Communications Commission, to Chairman, Committee on Energy and Commerce, U.S. House of Representatives, May 2, 1988). BellSouth also deems insufficient ITI's argument that state restrictions may hinder its marketing efforts, and notes that the Commission has recognized that any state regulation may somehow burden entry into the marketplace. *Id.* at 7 (citing People of the State of California v. Federal Communications Comm'n, 798 F.2d 1515, 1519 (D.C. Cir. 1986)). BellSouth further asserts that, under its plan because state certification is a prerequisite only to the delivery of pay telephone traffic, it may be obtained after balloting but before implementation of equal access. *Id.* at n.13.

20. In addition, BellSouth argues that its rate limitation is supported by the *Allocation Order*, and notes that it applies this requirement to allocated customers but not presubscribed customers. *Id.* at 10 n.18. BellSouth also contends that the requirement that carriers be able to process international traffic imposes no significant hardship on ICs and that impairment of international service would be detrimental to the public interest. *Id.* at 11. In addition, BellSouth contends that it will allow release of subscriber information to outside marketing agents as long as the designated agent will assume the same responsibilities for use and protection of proprietary data as are required of the IC. *Id.* at 12. BellSouth submits that removing all restrictions from release of customer data would enable COCOT providers to solicit specific customers so as to increase their share of the payphone market. *Id.* at 13.

21. Moreover, BellSouth contends, the 90-day requirement of the *Allocation Order* only referred to the interval between balloting and conversion of the end office to equal access and therefore does not apply to end offices already converted such as those now in question. *Id.* at 14. BellSouth asserts that its payphone proposal fits within the retroactive billing provisions of the *Allocation Order*, which establish an interval of 30 days between the mailing of ballots and implementation of changes of the primary IC. *Id.* (citing *Allocation Order*, 101 FCC 2d at 932). Furthermore, BellSouth notes, the Common Carrier Bureau rejected the same argument when advanced by MCI in relation to US West's pay telephone plan. *Id.*[9]

C. *SWB*

22. SWB's payphone tariff, which is unopposed, proposes to ballot locations which have converted to equal access or have committed to do so before June 1, 1989. SWB plans to include other end offices in its ongoing ballot and allocation schedule for business and residential customers. SWB D&J at 1-2. Like the proposals of the other BOCs, the SWB plan leaves the choice of IC to the premises owner, or "agent" of the end user. *Id.* at 1-1. SWB's plan is similar to the US West plan, which became effective as scheduled.[10]

D. *New York and New England*

1. In General

23. New York and New England propose to make available for purchase by ICs customer name and address lists, which include the billing and working telephone numbers of the public telephones located on their property. New York D&J at 4; New England D&J at 4. New York and New England will also provide interLATA traffic data by premises for each public telephone. New York D&J at 4; New England D&J at 4-5. They assert that payphones located on New York Telephone and New England Telephone premises will be allocated among car-

riers in the same manner as other pay telephones for which a presubscribed carrier has not been chosen during the balloting process. New York D&J at 5; New England D&J at 5.

24. New York and New England require, among other things, that participating ICs must accept calls made with a New York or a New England calling card, must not charge a rate higher than the highest rate charged by the dominant IC for like MTS-type services without the payphone end user's consent, and must comply with all applicable federal, state, and local regulations. New York D&J at 7; New England D&J at 7-8. The New York and New England plans also provide that carriers participating in the allocation process must, among other things, not impose any fixed monthly or nonrecurring charges to allocated premises owners without their consent.

2. Contentions of the Parties

25. On December 27, AT&T petitioned to suspend and investigate New York Transmittal 947. Also on December 27, ITI and United Artists Operator Services Corporation (UAOSC) filed petitions to reject or suspend and investigate Transmittal 947, and NTS filed for partial rejection of the tariff. In addition, AT&T filed a petition to suspend and investigate New England Transmittal 960. ITI and UAOSC petitioned to reject or suspend and investigate Transmittal 960, and NTS filed for partial rejection.[11] New York and New England, responding together, filed an opposition to the petitions on January 9, 1989.

26. AT&T argues that the requirement that an IC must accept New England and New York calling cards is an impermissible bundling of tariffed equal access services with unregulated, untariffed billing services and has no relation to the tariffed provision of access service. AT&T Petition at 4. AT&T submits that the Commission has ruled improper a carrier's attempt to condition provision of access on resolution of billing matters. *Id.* at 5 n.* (citing Southwestern Bell Telephone Company Tariff F.C.C. No. 68, Transmittal No. 1613, DA 88-318, released Mar. 9, 1988, at para. 8). In addition, AT&T argues that the price restriction imposed by New York and New England would lead to "anticompetitive and arbitrary price ceilings." *Id.* at 5-6. AT&T contends that New York and New England have no legitimate interest in overseeing the rates charged by ICs, and submits that a "dominant" IC does not exist. *Id.* at 6 & n.*.

27. ITI submits that, by virtue of the proposed pricing restriction, New York and New England effectively usurp the Commission's authority and attempt to regulate the rates of non-dominant carriers. *Id.* at 5-6. ITI argues that the BOCs may not restrict the flexibility of non-dominant carriers by setting both BOC rates for validation and billing and collection services and the ICs' rates for pay telephone service. *Id.* at 6. If the Commission's rules regarding non-dominant carriers are to be changed, ITI contends, those rules must be changed via a Rule Making and not a tariff proceeding. *Id.* at 7. Furthermore, ITI asserts, this restriction is inconsistent with the mandate that rates cannot be confiscatory and maintains that a carrier's rates may not be arbitrarily tied to those charged by another carrier. *Id.* (citing *Aetna Insurance Co. v. Hyde*, 275 U.S. 440, 447 (1928)).

28. ITI also questions the relevancy of the erratum to the *Allocation Order*. ITI argues that the erratum to the *Allocation Order* referred only to allocated customers and is thus not applicable to presubscription. *Id.* at 6. ITI additionally observes that the erratum applied to MTS-type rates and to customers, not end users. *Id.* at 9. In the payphone presubscription situation, ITI contends, the premises owner, not the end user, is the IC's customer. *Id.* ITI notes that the *Allocation Order* prohibits the imposition of a non-recurring charge on assigned customers without their consent. It argues that "customer" cannot denote "end user" in this instance because end users of pay telephones are transient and can therefore be assessed nothing but non-recurring charges. *Id.* at 10. Nor can an IC give a transient end user of a payphone 30 days' notice of a change in criteria as required in the *Allocation Order*, ITI maintains. *Id.* Furthermore, ITI contends, if the erratum is interpreted to limit rates to the MTS-type rates charged by the dominant carrier, all payphone providers would violate the *Allocation Order* because all operator-assisted payphone calls are billed at rates higher than MTS-type rates. *Id.* at 11.

29. ITI also doubts that a "dominant carrier" exists in light of changes in the pay telephone marketplace, and questions how carriers will determine end user consent. *Id.* at 11-12. ITI postulates that end user consent could be inferred by the end user's decision to place a call over a payphone clearly labeled with the identity of the IC. *Id.* at 12. In addition, ITI contends that the presubscription process is not the appropriate vehicle by which to enforce IC compliance with state certification, and that only the Commission is empowered to impose such a restriction. *Id.* at 15 n.6. ITI asserts that the state certification restriction favors AT&T to the detriment of smaller ICs. *Id.* at 17. Furthermore, ITI argues, this type of restriction is not included in the *Allocation Order*, which the *October 14 Order* dictated should govern payphone balloting and allocation. *Id.* at 17.[12] ITI also asserts that the *Allocation Order* does not require that participating ICs be able to terminate international calls. *Id.* at 19. Because the New York and New England plans require that all carriers be able to handle international and collect calls, ITI argues, New York and New England must intend that participating ICs should be equipped to handle international collect calls, a complicated task in light of billing differences between countries. *Id.*

30. UAOSC contends that the rate limitation proposed by New York and New England would unlawfully interfere with the states' regulation of intrastate communications, since that restriction applies to intrastate interLATA and intraLATA calls as well as interstate calls. UAOSC Petition (NYT) at 3-4. UAOSC notes that the New York Public Service Commission is currently considering whether a rate limitation should be adopted for AOS providers operating in New York. UAOSC Petition (NYT) at 4. UAOSC further contends that the plan proposed by New York and New England conflicts with the *Allocation Order* in that the price limitation mentioned in the erratum to that Order refers to allocated customers, not presubscribed customers. UAOSC Petition (NYT) at 5 & n.3.

31. UAOSC also claims that by referring to "the dominant" IC in its tariff rather than "a dominant" IC as used in the *Allocation Order*, New York narrows the Commission's plan. UAOSC Petition (NYT) at 7. UAOSC claims that the proposed rate limitation would impose substantial burdens on smaller ICs, such as forcing them to adopt different rate tables and rate structures for interstate, intrastate interLATA, and intrastate intraLATA traffic depending upon which carrier is the dominant carrier in

each of those jurisdictions. *Id.* at 7.[13] Even if the smaller carriers could make such changes, UAOSC maintains, it may not be cost effective for such carriers to adopt one set of rates for payphone end users and different rates for other end users.

32. NTS submits that the erratum to the *Allocation Order* applies only to assigned customers, not those who are presubscribed. NTS Petition at 2-3. In addition, NTS notes that the *Allocation Order* requires the consent of the customer to exceed the price limitation, while the New York and New England proposal requires the consent of the end user. *Id.* at 3. In the public telephone situation, NTS contends, the customer is not the end user but the premises owner. *Id.* NTS further contends that the rate limitation may ensure the continued dominance of AT&T, and argues that extension of the rate limitation to presubscription should only take place after careful consideration in the context of a full public hearing. *Id.* at 4. It observes that NYNEX has argued to the court that callers from non-allocated payphones should be treated like callers from allocated business and residential phones since neither has agreed in advance to use a certain carrier. *Id.* at 5. NTS argues that this is inaccurate since the end user, although he or she is not the presubscribed party, will be adequately informed of the identity of the presubscribed carrier and will have the chance to make another choice.

33. NTS also questions what constitutes consent in the payphone situation and maintains that the requisite consent should be given by the premises owner. *Id.* at 6-7. If end user consent is required, NTS argues, consent should be inferred in that the caller has received reasonable notification of the identity of the IC to which the payphone is presubscribed and has been informed of his or her ability to obtain rate information. *Id.* In addition, NTS submits that the Commission should not establish payphone presubscription guidelines via these tariff proceedings due to the lack of uniformity among the BOCs. *Id.* at 8-9.

34. In their joint opposition, New York and New England argue that the pricing restriction they propose is necessary to protect customers from excessively high rates. New York and New England assert that the United States District Court for the District of Columbia noted in its *December 23 Memorandum* [14] that end users of presubscribed and allocated payphones are akin to allocated business and residential customers and thus need similar protection against excessive rates. New York and New England Opposition at 3. New York and New England submit that the Commission and some states have acknowledged the questionable pricing practices of AOS companies. *Id.* at 4 & n.5. New York and New England also argue that since NYNEX provides carriers with the data necessary to validate calls made with a NYNEX calling card, ICs should be required to accept such calls from NYNEX payphones. *Id.* at 5. Failure to do so, they argue, would lead to customer confusion and dissatisfaction. *Id.*

35. In addition, New York and New England observe that, while the *December 23 Memorandum* held that a carrier may not require that an IC be state certified or have applied for certification as a condition to being listed on the ballot, the court recognized that a carrier must obtain state certification or transfer calls to a certified carrier in order to provide presubscribed payphone service. *Id.* at 5-6. New York and New England note that the court ordered the BOCs to allocate any pay telephones that are presubscribed to a carrier that has failed to make arrangements to provide intrastate interLATA service by the time presubscription is implemented. *Id.* at 6. Those BOCs assert that their state certification requirement comports with the court's holding because it applies to the commencement of service and not to the balloting process. *Id.* New York and New England also argue that their tariffs do not require the IC to terminate international collect calls, but merely require that the IC allow for the completion of originating international calls either directly or via transfer to another carrier.

E. *Ameritech*

1. In General

36. Ameritech believes that the restrictions its plan imposes are necessary for both presubscribed and allocated payphones because "[t]he carrier choice of the premises owner may not be in the best interest of the pay telephone user." Ameritech D&J at 1. Like the payphone presubscription plans of other BOCs, Ameritech's plan includes a rate restriction tied to the rates of the dominant IC, a state certification requirement, and an identification requirement. *Id.* at 1-2. Ameritech also requires, among other things, that the IC arrange for receipt of calls with the LATA of origin and that the IC subscribe to FGD access service in the end office where the payphone is located. *Id.* at 2. Ameritech states that such a requirement is necessary because it cannot provide interLATA service and because presubscription is only available with FGD. *Id.* Ameritech further provides that ICs must accept charge card, collect, and third number calls so as to "minimize the difference between the procedures for intraLATA and interLATA calls," and that ICs honoring Ameritech calling cards must do so on an automated basis in a manner equivalent to that used by Ameritech for its intraLATA traffic. *Id.* In addition, Ameritech requires that ICs use Automatic Number Identification (ANI) to record the telephone number of the originating station instead of asking the end user. *Id.*

2. Contentions of the Parties

37. On January 12, 1989, AT&T and MCI filed petitions to suspend and investigate Transmittal 251. Also on January 12, ITI and OSPA filed petitions to reject in part or suspend and investigate the Ameritech tariff, and NTS filed a petition for partial rejection. Ameritech filed its opposition to these petitions on January 26.

38. AT&T opposes Ameritech's price limitation, arguing:

> Such artificial restrictions on the factors, such as price, that differentiate the offerings of competing carriers have nothing to do with a LEC's provision of access services, and represent an unwarranted intrusion into the competitive interexchange market by a LEC that has no legitimate interest in overseeing [ICs'] rates.

AT&T Petition at 3. AT&T further argues that it would be discriminatory for Ameritech to deny equal access to an IC which does not abide by its pricing policies. *Id.* Moreover, AT&T asserts, IC rates and services are not matters to be discerned via a LEC's access tariff. *Id.*

39. MCI opposes Ameritech's requirement for automated validation of its calling card and contends that ICs should be allowed to process BOC calling cards in any way they choose. MCI Petition at 3. MCI further submits that Ameritech should make clear in its tariff that carriers are not required to accept Ameritech's card. *Id.* at n.5. Similarly, MCI argues that Ameritech may not dictate how ICs will accept charge card, collect, and third number calls, and may not force ICs to use ANI. *Id.* at 3-4. In addition, MCI notes that the United States District Court for the District of Columbia has held that state certification requirements in the BOC pay telephone proposals should be deleted. *Id.* at 4-5 (citing *December 23 Memorandum).* Finally, MCI maintains, regardless of the fact that the *Allocation Order* imposed price limitations on only allocated customers, Ameritech has not justified its proposed pricing restriction. *Id.* at 5.

40. ITI also opposes Ameritech's pricing restriction as an attempt to regulate the rates charged by non-dominant carriers in violation of the Commission's Rules. ITI Petition at 3-4. ITI submits that this issue would be more appropriately addressed in the context of a Rule Making proceeding and does not belong in a carrier's tariff. *Id.* at 4. ITI further argues that such a restriction is inconsistent with the principle that rates must not be confiscatory but must be calculated so that a carrier may recover its costs and earn a reasonable return. *Id.* at 5. As a result, ITI submits, a carrier's rates may not be restricted to those assessed by another carrier. *Id.* (citing *Aetna Insurance Co. v. Hyde*, 275 U.S. 440, 447 (1928)). ITI further observes that Ameritech's charges for access, validation, and billing and collection may account for half of the charge for a given call, and therefore contends that the ICs must be afforded reasonable rate flexibility. *Id.* ITI also asserts that the erratum to the *Allocation Order* applied only to allocated customers and deems the definition of "dominant carrier" unclear. *Id.* at 6-8. ITI further questions the determination of end user consent in the payphone context. *Id.* at 9.

41. In addition, ITI objects to Ameritech's state certification requirement and reiterates the arguments it raised regarding the state certification provisions of New York and New England. *Id.* at 10-12. ITI also opposes the Ameritech provision which mandates that ICs must subscribe to FGD in the end office where the payphone is located. ITI questions whether this proposed requirement means that an IC must establish its own FGD facilities as opposed to the current industry practice of relying on shared or resold facilities to access local exchanges. *Id.* at 13. If so, ITI asserts, the provision is discriminatory because AT&T is the only IC now able to comply. *Id.* Similarly, ITI maintains that since ANI is not always available with shared or resold FGD service, Ameritech's ANI requirement favors AT&T. *Id.* at 14. ITI further contends that Ameritech has offered no reason why ICs cannot choose their own methods of accepting credit card, collect, and third number calls. ITI also finds Ameritech's language regarding automated acceptance of its calling cards ambiguous, and opposes Ameritech's identification requirement as beyond its authority. *Id.* at 14-15.

42. ITI then objects to a moratorium on release of premises owner information which is not included in Ameritech's tariff filing but does appear in its payphone presubscription plan. ITI notes that the Ameritech plan prohibits IC release of premises owners' names and addresses with outside marketing staff unless the IC enters into a license agreement. *Id.* at 15-16. ITI asserts that it must employ outside marketing staffs in order to compete for premises owners, and maintains that Ameritech's limitation is not relevant to the presubscription process. *Id.* at 16-17. ITI doubts that premises owner data are proprietary since AT&T already possesses this information. *Id.* at 17 n.17.[15]

43. NTS opposes Ameritech's rate limitation, and argues that the erratum to the *Allocation Order* only applied to presubscribed customers. NTS Petition at 2-3. NTS further observes that the *Allocation Order* required the consent of the customer if an IC exceeds the rate cap and that Ameritech requires the consent of the payphone user or caller. *Id.* at 3. NTS asserts that the customer of a pay telephone is the premises owner and not the caller. *Id.* at 3. NTS further maintains that imposition of a rate limitation based on AT&T's rates "runs the risk of enshrining AT&T as a price leader." *Id.* at 4. NTS also disputes Ameritech's argument likening payphone end users to allocated customers, especially since the end user will be alerted to the identity of the presubscribed carrier and will have the opportunity to make another choice. *Id.* at 5. NTS further submits that consent should be inferred where the caller has been notified of the name of the IC and has been instructed how to obtain rate information via a placard on the phone. *Id.* at 6-7. NTS also contends that, due to the lack of uniformity among the BOCs, the rate limitation issue should be addressed on a national basis in the context of a Rule Making proceeding. *Id.* at 8-9.

44. OSPA also notes that the price limitation in the *Allocation Order* applied only to allocated customers. OSPA Petition at 7. OSPA further asserts that the identification requirement is beyond Ameritech's authority, and objects to the state certification requirement. *Id.* at 7-8. OSPA then contends that the provision regarding acceptance of credit card, collect, and third number calls is vague and does not comply with the *Allocation Order. Id.* at 8-9. OSPA argues that if the BOCs wish to expand the Commission's presubscription rules, they should petition for a Rule Making proceeding. *Id.* at 9-10.

45. While Ameritech concedes that the *Allocation Order* applied only to assigned customers, it argues that the price limitation described in that Order should extend to the payphone presubscription process. Ameritech asserts that payphone end users are assigned customers since the end users are assigned to an IC by the premises owner. Ameritech Opposition at 7. Ameritech submits that the end user of a payphone is even more deserving of protection than is the allocated business or residential user because payphone users receive no ballots and because the IC will be chosen by the premises owner, who may have interests which conflict with those of the end user. *Id.* at 7-8. Ameritech further asserts that the ever-increasing rates of non-dominant carriers, as well as surcharges imposed by premises owners, could lead to abuse of the presubscription process. *Id.* at 9-11.

46. Ameritech also observes that credit card, collect, and third-party calls are part of MTS service, thereby providing a proper frame of reference for the rate limitation. *Id.* at 12. In addition, Ameritech argues that the type of customer consent required by its pricing limitation need not be written consent, but must be more than inferred consent. *Id.* at 13-15. Ameritech proposes that the Commission require a statement that the charge for the call being placed will exceed the highest tariffed rate that

applies to similar calls. *Id.* at 15. It notes that carriers that object may avoid the requirement by maintaining rates below those of the dominant carrier. *Id.* at n.32.

47. In response to the *December 23 Memorandum* regarding state certification, Ameritech asserts that it will consider its state certification requirement met if a carrier that is not certified arranges to transfer intrastate calls to a state-certified IC. *Id.* at 16. Ameritech also asserts that the NECA provision rejected by the Commission, which is cited by ITI, would have prevented an end user from presubscribing his or her line to an IC that carries only interstate traffic. *Id.* at 16-17. Ameritech notes that the NECA tariff would have restricted an entire class of end users -- those whose calls were virtually all interstate. *Id.* at 17. In this proceeding, Ameritech argues, the customers in question are transient and a substantial amount of traffic from its pay telephones is intrastate. *Id.* If its state certification requirement is not permitted, Ameritech contends, intrastate calls from some public payphones might be blocked, leading to end user confusion that damages the reputation of Ameritech. *Id.* at 17-18. Ameritech further notes that, while the *Allocation Order* addressed only interstate service, its proposal necessarily involves intrastate service because it purports to eliminate the current practice of routing all calls, both interstate and intrastate, to AT&T. *Id.* at 19-20.

48. Although it will be affixing placards to the face of its pay telephones which name the primary IC, Ameritech submits, the requirement that ICs provide a recorded message will further alert the caller, will benefit visually-impaired end users, and will compensate for potential defacement of the placards. *Id.* at 23-24. In addition, Ameritech notes that the provision in its tariff that ICs accept charge card, collect, and third number charge arrangements is not really a requirement but is a description of pay telephone presubscription. *Id.* at 24-25. Ameritech further argues that the requirements that ICs use ANI and automated acceptance of the Ameritech calling card are extensions of the notion that ICs should strive to minimize the differences between intraLATA and interLATA procedures. *Id.* at 25-26. Ameritech contends that these requirements are necessary to reduce customer confusion and thereby protect its reputation. *Id.* at 26. Ameritech emphasizes that carriers are not expected to eliminate all differences, and notes that interexchange carriers may offer any additional billing arrangements they choose, such as bank credit cards, even though such arrangements are not presently accepted by Ameritech. *Id.*

49. Moreover, Ameritech asserts, its ANI requirement does not favor AT&T. Ameritech submits that the requirement applies to all ICs and will prevent erroneous billing if the number of the payphone is obscured or the user is visually-impaired. *Id.* at 27. It contends that the ANI requirement should not prove difficult for an IC since it is part of FGD service and the IC must have ordered FGD to receive undesignated interLATA payphone traffic. *Id.* Similarly, Ameritech argues that the requirement that all carriers accepting its calling card do so by automated means applies equally to all carriers, and is necessary to protect Ameritech's reputation. *Id.* at 28. Ameritech also observes that automated calling card procedures prevent the misuse which could result if persons other than the caller overhear the caller giving an operator his or her calling card number. *Id.*

50. Ameritech also asserts that its requirement that a carrier obtain FGD in the end offices where its payphones are located is appropriate since use of FGA and FGB would necessitate the dialing of additional digits. *Id.* at 29. Ameritech responds to ITI's argument that its requirement would preclude reliance on shared or resold facilities by observing that it has arranged with ITI to route ITI calls to another IC's trunk group via end office facilities. *Id.* at 29-30. Ameritech notes that ITI thereby will subscribe to FGD but need not construct its own facilities. *Id.* at 30.

51. Ameritech further argues that its restrictions on release of premises owner information ensures that such data will not be used for purposes unrelated to the presubscription process. *Id.* It notes that it has agreed to provide interLATA traffic data for each of its payphones by location once the IC completes a license agreement. *Id.* at 31. Ameritech also permits ICs to release the information to outside marketing agents (who are not also pay telephone providers) as long as the agents aver that the data will be used solely for purposes of presubscription. *Id.* Ameritech observes that the court denied ITI's motion for a rehearing regarding this issue, and argues that it does not already provide AT&T with aggregated premises owner data. *Id.* at 32 & n.58.

F. *Pacific and Nevada*

1. In General[16]

52. Pacific introduces "preselection" into its payphone plan applicable to public and semi-public pay telephones served by end offices converted to equal access on or before April 1, 1989. Pacific D&J at 1. Pacific avers that other public and semi-public pay telephones will be included in its ongoing implementation schedule for equal access conversion. *Id.*

2. Comments of the Parties

53. On January 17, 1989, NTS submitted a letter opposing the Pacific plan, and ITI filed a petition to reject or suspend and investigate the tariff. Pacific submitted its reply to the ITI petition on February 1.[17]

54. NTS notes that the Pacific tariff does not contain any express conditions on IC participation in pay telephone presubscription, but asserts that the Pacific plan filed with the United States District Court for the District of Columbia mandates that ICs may not charge more than 110 percent of the dominant carrier's rates. NTS Letter at 1-2. NTS argues that Pacific should place in its tariff any conditions it intends to impose on participating ICs. *Id.* at 3. If Pacific amends its proposal to include the rate restriction, NTS submits, it will oppose the Pacific tariff. *Id.*

55. ITI incorporates by reference the arguments it raised in its petition against the BellSouth payphone tariff (except regarding the use of premises owner information, which has not been restricted by Pacific). ITI Petition at 2. ITI contends that Pacific's tariff fails to state all of the restrictions Pacific plans to impose on participating ICs since many limitations were included in the pay telephone plan Pacific filed with the court. *Id.* at 3. ITI objects to some restrictions contained in Pacific's plan for the same reasons it opposed similar requirements proposed by other BOCs, particularly the state certification requirement, the limitation of rates to not more than 10 percent above those of the dominant carrier, and the

requirement that ICs be able to handle collect international calls. *Id.* at 4. ITI further notes that, like Ameritech, Pacific mandates that an IC must order FGD directly from the LEC and that the IC must identify itself to the end user before he or she is assessed any charge. *Id.* at 5. ITI reiterates the arguments it made in opposition to these provisions of the Ameritech tariff. *Id.* at 5-6.

56. The Pacific reply states that it will file tariff revisions to incorporate the restrictions it proposes to place on participating ICs. Pacific Reply at 3. Pacific plans to require (1) that ICs be able to offer service to any point within the continental United States; (2) that ICs do not impose any fixed monthly or non-recurring charges on the allocated premises owner without his or her consent; (3) that ICs accept the Pacific Bell or the Nevada Bell calling card; (4) that ICs charge rates for interLATA intrastate calls that do not exceed those of the dominant carrier by more than 10 percent; (5) that ICs order Pacific's FGD services; (6) that ICs have their own access customer name abbreviations (ACNAs) and carrier identification codes (CICs); (7) that the ICs be ANI and screen code sensitive; (8) that ICs provide international calling on their own or through a reseller or that they make arrangements with another carrier to provide such service; (9) that ICs accept collect and third number billing arrangements; (10) that ICs identify themselves to end users before any charges are incurred; and (11) that ICs comply with all applicable state and federal regulations. *Id.* at 3-9.[18]

57. Pacific asserts that its nationwide service requirement is necessary because pay telephone premises owners, not end users, will be making the presubscription choice. *Id.* at 4. Pacific also claims that its restriction regarding fixed monthly or non-recurring charges protects premises owners who fail to presubscribe. *Id.* at 4-5. In addition, Pacific submits that its calling card requirement is necessary to avoid customer confusion and dissatisfaction since approximately 50 percent of operator-assisted traffic involves calling cards. *Id.* at 5-6 (citing *October 14 Order* at 3, 9-10). Pacific also argues that its rate limitation is more flexible than that established in the *Allocation Order* in that it permits ICs to charge up to 10 percent above the dominant carrier's rates, but asserts that it still protects end users from exorbitant charges. *Id.* at 6. Pacific contends that the price limitation should apply to both allocated and presubscribed pay telephones because the premises owner, who makes the presubscription decision, has interests different from those of the end user. *Id.* at 6-7.

58. Pacific further asserts that its FGD requirement mirrors that of the *Allocation Order*, and argues that its ACNA and CIC requirements are necessary to assure proper end office translations, routing, and application of access charges. *Id.* at 7. Pacific also notes that ICs must be ANI and screen code sensitive because some pay telephones use specialized screening to minimize fraud. *Id.* at 7-8. Regarding international service, Pacific notes that there is a significant demand in California and Nevada for the ability to place international calls from pay telephones. *Id.* at 8. In addition, Pacific submits that because many end users opt to place collect and third-number-billed calls rather than calling card calls, ICs should be prepared to accept such arrangements. *Id.* at 8-9. Pacific also observes that, although each of its pay telephones will carry a placard identifying the presubscribed IC, its identification requirement is necessary because such placards might be vandalized. *Id.* at 9. Finally, Pacific contends that ICs must be required to comply with state and federal regulations "to protect end users and premise owners from being forced to deal with entities that refuse to comply with applicable laws and regulations." *Id.*

III. DISCUSSION

59. The majority of the payphone presubscription tariffs now under consideration contain various interexchange carrier restrictions. These restrictions include, for example, requirements that ICs charge rates no higher than those of the dominant carrier, obtain state certification, accept BOC calling cards, and process international calls. Other matters raised by petitioners include the definition of customer consent, the release of premises owner information, and the imposition of service quality requirements (particularly the 5-second response time mandated by Bell Atlantic). In addition to these tariffed restrictions, it is evident that certain LECs anticipate imposing interexchange carrier restrictions that are not described in their tariffs.

60. Upon extensive review of the proposed restrictions and related pleadings, the Common Carrier Bureau finds that these requirements do not constitute just and reasonable regulations and therefore are unlawful under the provisions of Section 201(a) of the Act. We also conclude that such provisions were not contemplated by the Commission's *Allocation Order*, which stated that the LECs should determine presubscription procedures for pay telephones "and inform the [ICs] of their decision."[19] The Commission, in calling for the development of payphone presubscription procedures by the LECs, did not contemplate the imposition by the LECs of broad restrictions upon the choice of interexchange carriers or LEC-imposed restrictions upon interexchange carrier rates or practices. US West correctly interpreted this limited reference to payphone presubscription by filing a tariff which does not impose myriad restraints on participating ICs.[20] Because SWB and BellSouth have done the same, we are accepting the SWB and BellSouth tariffs without suspension or investigation. All other payphone presubscription tariffs under consideration in this Order are rejected.

61. The Commission and this Bureau have previously rejected restrictions on customers' use of services. For example, the Commission's *Carterfone Decision*[21] ordered AT&T to modify its tariff so as not to prohibit use of an interconnection device. The Commission based its finding on the holding in the *Hush - A - Phone Decision*[22] "wherein it was held that tariffs cannot be sustained which impose an unwarranted interference with the telephone subscriber's right reasonably to use his telephone in ways which are privately beneficial without being publicly detrimental."[23] Similarly, this Bureau's *May 20 WATS Order* concluded that the LECs' imposition of use restrictions which permitted only certain access lines to be used for WATS, or restricted the type or amount of traffic to be transmitted over any special access line "violate the intent and purpose of the access charge rules."[24]

62. Similar considerations lead us to conclude that the restrictions imposed by these payphone prescription plans are unlawful. The LECs are required, because of their obligations as common carriers and because of the provisions of the Commission's access rules, to provide access service free of LEC-initiated restrictions. To the extent that LECs seek to encumber the general availability of

their access services by forcing customers to abide by a range of requirements and restrictions in order to be eligible to receive the access services, the LECs are in effect seeking to turn themselves into regulators of the manner in which the interexchange carriers may utilize access services. That responsibility has not been delegated to the LECs.

63. LEC-imposed restrictions upon users of their access services also create the risk that LECs will engender restrictions which further the LECs' own interests. For example, the requirement that ICs must accept BOC credit cards in order to be eligible to participate in the presubscription process would seem to have more to do with promoting BOC business interests than with designing reasonable presubscription procedures.

64. We are not persuaded by carrier claims that the maximum rate restrictions for interexchange carriers implement the Commission's *Allocation Order*. Various petitioners have correctly noted that the *Allocation Order* does not require interexchange carriers to adhere to particular rates to be included on the ballot. The LECs cannot lawfully impose requirements for inclusion in the ballot that have not been mandated.

65. Our conclusion regarding the legality of the LECs' proposed payphone tariffs, however, does not alter the fact that we harbor several concerns regarding the effect of pay telephone presubscription on end user customers. In fact, in a recent complaint proceeding regarding AOS providers, this Bureau imposed carrier identification requirements similar to those proposed in the LECs' payphone tariffs.[25] That Order mandates that carriers identify themselves to the end user via placards on the telephones and on line prior to assessment of charges. The Bureau further ordered carriers to provide customers with rate information upon request. Some of the other restrictions proposed by the carriers are likewise enforceable through means other than carrier-initiated tariff restrictions. For example, Sections 68.4 and 68.112 of the Commission's Rules, 47 C.F.R. §§ 68.4, 68.112, require that pay telephones be equipped to assist hearing-impaired end users.

IV. CONCLUSION; ORDERING CLAUSES

66. The Common Carrier Bureau has reviewed the tariff transmittals, the supporting materials, and the pleadings, and we conclude that the tariffs referenced herein violate Section 201(b) of the Communications Act and therefore must be rejected. Excepted are the SWB and BellSouth tariffs, which will become effective as scheduled. In the event that any carrier desires to refile its tariff reflecting revisions necessary to comply with this Order, it may make such a filing on 10 days' notice. For purposes of any such refiling, the Bureau will consider reasonable any tariff provisions which are consistent with the provisions and procedures set forth in the Commission's Order regarding presubscription of business and residential telephones.[26]

67. Accordingly, IT IS ORDERED that the petitions opposing the Bell Atlantic Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 276; New York Telephone Company Tariff F.C.C. No. 41, Transmittal No. 947; New England Telephone Company Tariff F.C.C. No. 40, Transmittal No. 960; the Ameritech Operating Companies Tariff F.C.C. No. 2, Transmittal No. 251; the Pacific Bell Telephone Company Tariff F.C.C. No. 128, Transmittal No. 1391; and the Nevada Bell Telephone Company Tariff F.C.C. No. 1, Transmittal No. 73 ARE GRANTED to the extent indicated herein, and the tariffs ARE REJECTED.

68. IT IS FURTHER ORDERED that the petitions opposing the BellSouth Telephone Companies Tariff F.C.C. No. 1, Transmittal No. 204 ARE DENIED.

69. IT IS FURTHER ORDERED that the above-referenced companies whose tariff filings are rejected SHALL FILE tariff revisions not later than March 15, 1989, to become effective on one day's notice, in order to remove rejected material from their tariffs. For this purpose, Sections 61.58 and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.58, 61.59, are waived and Special Permission No. 89-189 is assigned.

70. IT IS FURTHER ORDERED that the above-referenced companies whose tariff filings are rejected may file tariff revisions reflecting provisions in compliance with this Order not later than March 15, 1989, to become effective on not less than 10 days' notice. For this purpose, Sections 61.58 and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.58, 61.59, are waived and Special Permission No. 89-190 is assigned.

FEDERAL COMMUNICATIONS COMMISSION

Gerald Brock
Chief, Common Carrier Bureau

FOOTNOTES

[1] Public pay telephones are those payphones located in public areas such as airports, bus and train stations, hotel or office building lobbies, and public streets which are available for use by the general public. Semi-public payphones are located in areas used for both business and public calling such as service stations, laundromats, and restaurants. Bell Atlantic Description and Justification (D&J) at 1-2.

[2] United States v. Western Electric Co., CA No. 82-0192, Order (D.D.C. Oct. 14, 1988) (*October 14 Order*).

[3] Investigation of Access and Divestiture Related Tariffs, 101 FCC 2d 911 (1985) (*Allocation Order*).

[4] On November 15, 1988, Bell Atlantic filed Transmittal 276. On November 23, BellSouth filed Transmittal 204. SWB filed Transmittal 1742 on December 2, 1988. On December 8, New York filed Transmittal 947, and on December 9, New England filed Transmittal 960. Ameritech filed Transmittal 251 on December 28. On December 30, Pacific filed Transmittal 1391 and Nevada filed Transmittal 73. The SWB tariff is unopposed. It also should be noted that Southern New England Telephone Company filed a pay telephone presubscription tariff in Transmittal No. 458 on February 2, 1989. That tariff, scheduled to take effect on March 9, 1989, will be addressed in a subsequent Order.

[5] On January 9, 1989, National Telephone Services (NTS) filed comments opposing the pricing limitation proposed by Bell Atlantic. Because NTS filed its comments after the pleading cycle had closed, and since NTS raises no issues beyond those already advanced by petitioners, we do not consider the NTS comments. On January 19, 1989, Cleartel Communications (Cleartel) submitted a letter opposing all of the BOCs' payphone presubscription plans. Cleartel also does not raise any new issues and its comments likewise are not considered.

On February 9, 1989, PayCom Systems Corporation (PayCom), a Customer-Owned Coin-Operated Telephone (COCOT) vendor, submitted a letter noting disparities in the assessment of carrier access line charges (CALCs) on pay telephone providers. PayCom asserts that while COCOT vendors must pay local exchange carriers monthly CALCs of $6 per line, the BOCs will not pay CALCs for their pay telephones since the BOCs will not assess such charges on themselves. PayCom Letter at 1. PayCom maintains that this will harm competition and submits that either the premises owner should be responsible for paying the charges, or the BOCs should be required to assess CALCs on themselves. *Id.* at 2.

[6] MCI notes that the United States Department of Justice has written to each of the Bell Operating Companies (BOCs), expressing concern that the BOCs will impose restrictions which exceed the requirements of the *Allocation Order*. MCI Petition at n.2.

[7] Investigation of Access and Divestiture Related Tariffs, Memorandum Opinion and Order, 101 FCC 2d 911 (1985) (*Allocation Order*).

[8] On January 9, 1989, NTS filed comments regarding Transmittal 204. BellSouth responded to the NTS comments on January 24. Because NTS filed its comments after the pleading cycle had closed, and since NTS raises no issues beyond those already advanced by petitioners, we do not consider the NTS comments.

[9] This issue is moot. On January 5, 1989, the court issued an Order which stated that no pay telephone customer shall be converted prior to 90 days after ballots were mailed to that customer, or April 1, 1989, whichever is later. United States v. Western Electric Co., C.A. No. 82-0192, Order (D. D.C. Jan. 5, 1989).

[10] *See* Mountain States Telephone and Telegraph Company, Northwestern Bell Telephone Company, and Pacific Northwest Bell Telephone Company, Tariff F.C.C. No. 1, Transmittal Nos. 174 and 210, DA 88-1886, Order, released Dec. 7, 1988.

[11] While all petitioners filed separately regarding the New York and New England tariffs, the two pleadings filed by each petitioner are substantially similar. As a result, references to a party's petition opposing the New York and New England tariffs will be to the petition against the New England tariff unless otherwise noted.

[12] *See October 14 Order* at 3.

[13] UAOSC presumes that New York Telephone would be deemed the dominant carrier in New York, but notes that New York Telephone maintains different rate schedules for the different New York LATAs. UAOSC Petition (NYT) at 8.

[14] United States v. Western Electric, C.A. No. 82-0192, Memorandum, issued Dec. 23, 1988 (*December 23 Memorandum*).

[15] ITI also notes that Ameritech has objected to a provision contained in the agreements between ITI and premises owners whereby public payphones may be replaced with COCOTs, and that Ameritech maintains that ITI wants usage data for this purpose and not to facilitate presubscription. ITI asserts that Ameritech thus "impermissibly ties" presubscription to the replacement of payphones merely because they appear in the same agreement, and requests the Commission to declare such conduct a violation of the Communications Act. ITI Petition at 16 n.15. We conclude that the argument ITI raises is outside the scope of this proceeding.

[16] Because the Pacific and Nevada tariffs are virtually identical, all references made herein will refer to the Pacific tariff.

[17] Pacific asserts that its reply comments were filed late because it did not become aware of ITI's petition until January 27. Pacific notes that the petition was served via first class mail to the wrong Pacific Bell executive. *See* Pacific Motion To Accept Late Filed Reply, filed Feb. 1, 1989.

[18] Pacific and Nevada have since amended their tariffs to include IC restrictions via Transmittal No. 1401 and Transmittal No. 79, respectively.

[19] *Allocation Order*, 101 FCC 2d at 932.

[20] *See* Mountain States Telephone and Telegraph Company, Northwestern Bell Telephone Company, and Pacific Northwest Bell Telephone Company, Tariff F.C.C. No. 1, Transmittal Nos. 174 and 210, DA 88-1886, Order, released Dec. 7, 1988 (*US West Payphone Order*).

[21] Use of the Carterfone Device in Message Toll Telephone Service, 13 FCC 2d 420 (1968), *recon. denied*, 14 FCC 2d 571 (*Carterfone Decision*).

[22] Hush-A-Phone Corporation v. United States, 238 F.2d 266 (D.C. Cir. 1956) (*Hush - A - Phone Decision*).

[23] *Carterfone Decision*, 13 FCC 2d at 439.

[24] Annual 1986 Midyear Access Tariff Filings, Memorandum Opinion and Order, Mimeo No. 4621, released May 20, 1986, *recon. denied*, 1 FCC Rcd 1247 (1986) (*May 20 WATS Order*).

[25] *See* TRAC v. Central Corp., Int'l Telecharge *et al.*, File Nos. E-88-104 through E-88-108, DA 89-237, Memorandum Opinion and Order, adopted Feb. 24, 1989.

[26] Investigation of Access and Divestiture Related Tariffs, 101 FCC 2d 911 (1985) (*Allocation Order*).

Before the
Federal Communications Commission
Washington, D.C. 20554

MM Docket No. 88-375

In the Matter of

Amendment of Part 73 of the Rules to provide for an additional FM station class (Class C3) and to increase the maximum transmitting power for Class A FM stations	RM-6236 RM-6237

FIRST REPORT AND ORDER

Adopted: March 30, 1989; Released: April 10, 1989

By the Commission:

INTRODUCTION

1. The Commission herein amends Part 73 of its rules to create an additional class of FM broadcast stations, designated "Class C3", to be available throughout most of the United States. This new station class will provide opportunities for some existing Class A FM station licensees to expand their coverage areas and thereby better serve their radio audiences. Also, the availability of an another intermediate class of FM facility in sparsely populated areas may make additional new stations economically feasible. For these reasons, we believe that this action will promote a competitive marketplace for the development and use of broadcast facilities and services, further develop a regulatory framework that permits markets for broadcast services to function effectively, and improve efficiency in the allotment, licensing, and use of the electromagnetic spectrum.

BACKGROUND

2. On July 20, 1988, the Commission adopted a *Notice of Proposed Rule Making* (*Notice*) setting forth for public comment various proposed rule amendments that would potentially permit improvements in the facilities of the majority of Class A FM broadcast stations in the United States.[1] Specifically, the Commission proposed the creation of a new intermediate class of FM broadcast stations in Zone II[2], and a general increase in the maximum permitted transmitting power for Class A FM broadcast stations.[3]

3. In response to the *Notice*, the Commission received 98 formal comments, 16 reply comments, and several hundred informal letters and inquiries. Most of these comments and letters address issues related to the Class A power increase proposal, and some of them address the matter of the proposed new C3 station class as well. It is apparent from our initial review of these pleadings that there is sharp disagreement among the parties as to how any increase in transmitting power for Class A stations should be implemented, and that further study of the positions advocated in the comments, consideration of administrative details, and additional technical analysis is necessary before we decide that matter.

4. By contrast, the majority of comments addressing the new C3 station class agree in favoring the rules proposed to provide for such a station class. The commenters confirm our tentative conclusion that the creation of this new station class will improve spectrum utilization in Zone II and afford opportunities for at least some of the Class A stations in Zone II to expand coverage, thereby allowing these stations to provide improved service to their audiences. Because the technical and administrative issues associated with the Class C3 proposal are comparatively simple, and there is among the commenting parties a nearly universal consensus in support of the proposed rules, it appears that prompt consideration of the Class C3 rules, separate from action on the proposed Class A power increase, is appropriate. Furthermore, we note that Rule Making proceedings to amend the Table of Allotments (by upgrading Class A allotments to Class C3 or adding new Class C3 allotments) are necessary before any Class C3 station assignments can be made. As these allotment proceedings will require additional time, we believe that the public interest will be served best if we adopt the Class C3 rules in an expeditious manner. Accordingly, we are issuing this *First Report and Order* to adopt rules providing for the new C3 FM broadcast station class and will consider the matter of the Class A power increase separately.[4]

THE CLASS C3 PROPOSAL

5. In the *Notice*, we proposed to add a new class of FM broadcast station in Zone II, Class C3, to be an intermediate class between Class A and Class C2, with a maximum effective radiated power (ERP) of 25 kilowatts and a reference antenna height above average terrain (HAAT) of 100 meters (328 feet). We noted that the proposed ERP/HAAT combination would produce coverage midway between that of existing Classes A and C2, but invited comments as to whether some other combination might be more appropriate.[5]

6. Additionally, we proposed to revise the table of minimum distance separation requirements for domestic FM commercial broadcast stations by adding appropriate distances for the new Class C3. The distances we proposed, except for the intermediate frequency (IF) distances, were calculated by assuming a primary service area for Class C3 facilities bounded by the 1 mV/m (60 dBu) F(50,50) field strength contour.[6] Consistent with our proposal in MM Docket 86-144, the IF distances proposed for Class C3 were calculated to prevent overlap of the predicted 36 mV/m (91 dBu) contours of IF-related stations.[7] On the basis of these distances, we estimated that roughly 15 percent of the current Class A assignments in Zone II would be able to upgrade to the new Class C3 at their current locations.

7. We restated in the *Notice* our desire to assign FM broadcast stations in a manner that provides adequate protection to existing service but does not preclude additional allotments or assignments by protecting vast areas not actually served.[8] Accordingly, we proposed to reclassify, after a specific time period, existing stations continuing to operate with facilities that result in less predicted coverage than is normally expected for the pertinent station class. In particular, we proposed that any

Class C2 stations operating with an ERP of 25 kW or less and an antenna HAAT such that the reference distance is less than 39 km be subject to reclassification to the new Class C3. Additionally, we proposed that the few Class C stations operating with (grandfathered) ERP greater than 100 kW, but with an antenna HAAT such that the reference distance is less than 72 km, be subject to reclassification to Class C1. As for the time period, we proposed to inform the affected licensees of their status and then allow a three year period during which they would be able apply for modification of their facilities to meet the criteria for classification under their current station class, or otherwise be subject to reclassification. The proposed procedures are consistent with those we used successfully in BC Docket 80-90 to insure that FM station classifications are commensurate with the sizes of the areas served.

SUMMARY OF THE COMMENTS

8. Of the 98 formal comments filed in response to the *Notice*, 43 addressed the Class C3 proposal. All but one favored the proposal without major changes. The lone comment in opposition was filed jointly by National Public Radio and the Corporation for Public Broadcasting (NPR/CPB).[9] Also, 3 of the 16 reply comments addressed the Class C3 proposal. All three reiterated support for it.

9. The joint comments of Albert L. Crain and Ouachita Communications (Crain/Ouachita) are typical of the supportive filings. Crain/Ouachita states that addition of the C3 Class would increase the efficiency and flexibility of the Commission's classification scheme. Noting the considerable gap between the coverage area of a Class A station and a Class C2 station, Crain/Ouachita indicates that a number of Class A stations could significantly increase power, but are unable to do so because of the large difference in the spacing requirements pertaining to Class A and Class C2 stations. Adding the new intermediate classification between Class A and Class C2 would create a new alternative that would allow the aforementioned stations to increase their coverage area. Crain/Ouachita summarizes its position in regard to the Class C3 proposal as follows:

> "The additional power which a Class C3 station could use would both improve the quality of the station's signal in the areas now served and extend the station's signal into previously unserved areas. Consequently, the listening public would have more stations to choose among and would receive better quality service from currently available stations."[10]

Greater Media, Inc. (Greater Media), in comments, also supports the Class C3 proposal, stating that the new Class C3 is "a good proposal, based on sound engineering standards and grounded in sound policy considerations," and that the public would be well served by its adoption.[11]

10. The Alpha Group (Alpha) adds that the creation of a new Class C3 is sensible from an economic standpoint. Alpha explains that while some broadcasters might hesitate to consider the costs of an upgrade from Class A to Class C2, the facilities of a Class C3 station would be comparatively more affordable. Alpha states that the creation of the new Class C3 would constitute not only a refinement of the FM allotment and assignment processes, but also a "streamlining of business opportunities . . . ."[12] Commenter E. Harold Munn, Jr. & Associates, Inc. (Munn) agrees that the Class C3 proposal would make station upgrades more economical to operators in small communities. Munn indicates that, in a number of cases studied, current antennas and transmission lines could still be used, and that only a change of transmitter would be required. Consequently, Munn infers, the costs and other disadvantages of antenna site relocation *(e.g.*, FAA approval of a different tower) would be avoided.[13]

11. Munn states that establishment of Class C3 would provide "a useful tool for improvement of FM service in the less densely populated areas of the nation" and adds that the gap between Class A and Class C2 facilities is so large that reasonable, interference-free expansion may not be available to the Class A operator who nevertheless needs to include service to small communities in order to have a viable operation.[14]

12. On the other hand, NPR/CPB opposes the Class C3 proposal[15] because it believes that the growth potential for public radio stations operating in the reserved portion of the FM band would be adversly affected by improvement of Class A commercial facilities. Most affected, according to NPR/CPB, would be public radio stations operating on FM Channels 218, 219 and 220, channels that are particularly important for reserved band public radio service in areas where TV Channel 6 is also assigned.[16]

13. NPR/CPB alleges that the proposal to create a new C3 class of commercial FM stations is unwarranted for three reasons. First, NPR/CPB notes recent Commission actions intended to provide additional opportunities for new and improved FM service,[17] and argues that the Commission should "wait to observe the results of these expansion efforts before it embarks on further major revisions of the FM allocation system." Second, NPR/CPB claims that the addition of a new class of FM station would require a major revision of the spacing relationships of commercial FM stations. Such a revision, according to NPR/CPB, may result in interference to the service of Class B FM stations and "erode the ability of such stations to serve their intended audiences." Lastly, NPR/CPB points out that noncommercial stations could be further restricted in site moves and power increases because of greater distance separation requirements for Class C3 operation compared to Class A operation.[18]

14. Those commenters favoring creation of Class C3 unanimously support the maximum ERP (25 kilowatts) and reference HAAT (100 meters) proposed for the new Class C3. All but one, Susquehanna Radio Corp. (Susquehanna), also concur with the proposed distance separation requirements, which were calculated on the basis of a primary service area bounded by the 1 mV/m (60 dBu) contour. Susquehanna supports the use of the same spacings applicable to Class B1 stations, but does not offer any explanation for this preference.[19] The reasons most often cited by the majority of the commenters for basing the distances on the 1 mV/m contour are: (1) that more C3 allotments could be made than if the Class B1 distances were to be used, and (2) that using the 1 mV/m contour would be consistent with the existing practice for all other FM stations in Zone II.

15. No commenters oppose, and several support, the proposal to reclassify, after a specified time period, existing stations continuing to operate with facilities that result in less predicted coverage than is normally expected for the pertinent station class. Greater Media supports the use

of a three year period, noting that this policy was succesful when applied to Class C stations in BC Docket 80-90.[20] However, du Treil, Lundin & Rackley (dLR) and Karl D. Lahm, P.E. (Lahm) suggest that a three year period is not warranted and that a shorter period would be more appropriate. The three year period may have been warranted in BC Docket 80-90, according to dLR, where many stations were affected and site relocations were sometimes necessary. dLR explains that its database indicates that fewer than 40 stations would be affected and that the solution for these stations is to increase power to the minimum Class C2 level. To permit these few stations three years to apply for minimum facilities seems, to dLR, overly generous. Lahm agrees, commenting that six to twelve months from the effective date of the Class C3 rules should be adequate time.[21]

DISCUSSION

16. After consideration of the record developed in this proceeding with regard to the Class C3 proposal, we conclude that the adoption of rules providing for such a class is in the public interest. We find that the potential benefits of the additional intermediate FM station class are significant and easily outweigh the minor administrative costs of its implementation.

17. Although the Class C3 rules we are adopting today will potentially help only ten to fifteen percent of Class A stations, those stations will be able to provide much better service with, in many cases, a relatively modest expenditure. Class C3 stations, with their greater power, will have much better coverage than Class A stations and will thus promote better spectrum utilization. Moreover, we expect that some new Class C3 stations may be established in Zone II areas where a Class C2 allotment is not possible because of spacing requirements, and a Class A facility has been considered to be economically infeasible.

18. We disagree with NPR/CPB that the creation of a new intermediate class of FM stations is unwarranted. Adoption of these Class C3 rules is a logical extension of our actions in BC Docket 80-90 and MM Docket 86-144 and will further improve spectrum utilization by providing additional opportunities for new and improved service. The Class C3 facility will fill the coverage "gap" between Class A and Class C2 facilities, and is a refinement to our classification scheme that will provide a more complete range of facilities in Zone II. We see no public benefit to delaying these rules until the full results of our earlier actions are realized.

19. We also disagree with NPR/CPB's contentions that the Class C3 rules constitute a major revision of the FM allocation system and spacing table that could harm the service of Class B stations. We are adopting appropriate distance separation requirements that will provide full protection to the service of all existing stations and allotments, including Class B stations. This will add only seven new lines to the distance separation table, and will not alter any of the existing distances. Thus, we do not consider this action to be a major revision.

20. However, as we recognized in the *Notice*, the assignment of Class C3 facilities may in some cases have a restrictive effect on possible future relocations and changes in facilities for non-commercial educational FM stations, particularly in markets where a Channel 6 TV station operates. Because we believe that it is appropriate to ensure the continued availability of adequate non-commercial educational FM radio service in such markets, we will continue to apply the "heavy burden" policy we developed in the *First Report and Order* in MM Docket 86-144 to Class A upgrades on Channel 221, in order to lessen any possible hardship on non-commercial educational FM stations.[22] We are revising the Note following paragraph 1.420(h) of our Rules (which advises Class A licensees seeking a class upgrade on Channel 221 of the heavy burden policy) to include a reference to the new Class C3.

21. Turning to the technical matters, we find that the proposed maximum ERP of 25 kW and reference antenna HAAT of 100 meters are appropriate for the new class. These facilities will provide a predicted coverage area approximately midway between those of Class A and Class C2 stations.[23] We also find that the proposed minimum distance separation requirements are appropriate. The co-channel, and the first, second and third adjacent channel distances are based on a Class C3 primary service area bounded by the F(50,50) 1 mV/m (60 dBu) field strength contour. In this regard, we agree with the commenters that the distances calculated in this way are technically consistent with those currently applicable to all other station classes in Zone II, and will allow more Class C3 allotments to be made than if the existing Class B1 separations were applied. Concerning the IF distance separation requirements for the new Class C3, we are adopting the proposed distances, which conform to the uniform 36 mV/m protection level that we established in our recent action in MM Docket 86-144.[24]

22. The record in this proceeding supports our proposal to employ the same reclassification procedures we used in BC Docket 80-90,[25] in order to ensure that FM station classifications are commensurate with the size of the area actually served, and to prevent stations that do not meet minimum service requirements from receiving excessive protection, thereby precluding other operations. In the *Notice*, we proposed a three year period for stations facing reclassification to file for modification to meet the minimum requirements for their class, as this is the time period we afforded stations subject to reclassification in BC Docket 80-90. However, we agree with Lahm and dLR that three years may be unnecessarily long in this instance. Most of the stations involved in the BC Docket 80-90 reclassification were Class C stations that did not meet the then new 300 meter minimum antenna HAAT requirement. Before filing for modification of facilities, licensees of those stations wishing to avoid reclassification needed to plan, design, and obtain financing and local approval for the construction of a taller tower, and in some cases, a site relocation. In view of the possibility of these complications, the three year period was deemed necessary. By contrast, the Class C2 licensees affected by our action herein[26] can avoid reclassification by simply increasing power. Many appear to be operating with just under the required minimum power and will be able to avoid reclassification by filing for a minor power increase (*e.g.*, from 25.0 to 25.1 kW). Because we believe that the preparations licensees need to undertake in order to file for modification of facilities (as a result of the creation of Class C3) are less time consuming than was the case in BC Docket 80-90, we find that a two year period is sufficient time to allow for these filings. Accordingly, we are establishing a date two years from the effective date of this order by which parties subject to reclassification[27] must apply for at least the minimum facilities for their

current class as set forth in Section 73.211 of the Rules as amended, or be reclassified, with the new class to be determined in accordance with Sections 73.210 and 73.211 of the Rules.

23. In processing applications from parties seeking to avoid reclassification pursuant to this order, we believe that the public interest will be best served if we follow the policy established for reclassification of allotments pursuant to BC Docket 80-90. Specifically, for each application filed prior to the deadline and not reached for processing until after the deadline, we will afford the applicant one opportunity to correct all deficiencies in the application. Upon finding a deficiency in a timely filed application, our staff on its own motion will waive the "hard look" FM processing rules,[28] and notify the applicant of the deficiency, rather than returning the application. The applicant will then have 30 days within which to correct the noted deficiency and any other deficiencies in the application. If after the 30 day period the application still contains one or more deficiencies, it will be returned *and the allotment reclassified*. Thereafter, the allotment could be returned to its prior classification only through filing and subsequent grant of a petition for rule making to amend the Table of FM Allotments.

24. For purposes of compliance with the provisions of the Canada - United States FM Broadcast Agreement (and Working Arrangement), Class C3 allotments and assignments within 320 kilometers of the border will be considered to be Class B1. Similarly, for the purposes of compliance with the provisions of the Mexico - United States FM Broadcasting Agreement, Class C3 allotments and assignments within 320 kilometers of the border will be considered to be Class B. This procedure is necessary until agreements incorporating the new C3 station class can be negotiated with these countries.

25. As proposed in the *Notice*,[29] we are revising paragraph (b)(3) of Section 73.211, which sets forth power and antenna height requirements for stations located in Puerto Rico and the Virgin Islands, to conform this paragraph to the current system for station maximum limits. This is an editorial change only and does not prejudge any action we may take with regard to the Class A power increase proposal as it may affect Puerto Rico and the Virgin Islands.

26. Our Mass Media Bureau has identified approximately 150 existing Class A stations that apparently can be upgraded to Class C3 at their current locations and on their currently assigned channels, without precluding any other Class A to Class C3 upgrades.[30] Rather than to require individual petitions for rule making from licensees and permittees of these stations who desire to upgrade their stations to Class C3, the Bureau intends to issue an omnibus notice of proposed rule making proposing the upgrade of these allotments. This omnibus proceeding will not preclude any other parties from filing timely petitions for Rule Making to amend the Table of FM Allotments[31] in accordance with our existing procedures. We believe that this approach will spare these licensees and permittees some effort and expense and will conserve our staff resources as well.

CONCLUSION

27. We believe that the potential public benefit of the new intermediate class of FM stations (Class C3) warrants its incorporation into our existing regulatory structure. We are establishing appropriate technical criteria that will enable the new station class to provide additional opportunities for significantly expanded FM service (particularly for existing Class A stations) as well as some new service, while fully protecting all existing service. We are also continuing our "heavy burden" policy to ensure that the upgraded service resulting from the creation of Class C3 does not unduly restrict non-commercial educational radio stations operating in the vicinity of Channel 6 TV stations. Finally, we are providing for reclassification of stations operating with less than the expected minimum facilities for their class. These actions will contribute to our policy goal of ensuring that the FM broadcast spectrum is effectively utilized.

FINAL REGULATORY FLEXIBILITY ANALYSIS

28. Pursuant to the Regulatory Flexibility Act of 1980, the Commission's final analysis is as follows:

I. Need and Purpose of this Action:

The Commission is adding an additional station class to its existing FM broadcast station classification system. The principal purpose of this action is to provide additional opportunities for improvement of the facilities of existing Class A FM broadcast stations. The need for such improvement was outlined in the *Notice* and confirmed by the majority of the commenting parties. An additional purpose of this action is to provide additional opportunities for new service in areas where Class A operation is economically unfeasible and Class C2 operation is technically unfeasible.

II. Summary of Issues Raised by the Public Comments in Response to the Initial Regulatory Flexibility Analysis:

No commenters addressed the Initial Regulatory Flexibility Analysis.

III. Significant Alternatives Considered and Rejected:

There are no alternatives to the action herein that would accomplish the stated purpose. Another proposal in the *Notice*, to increase the maximum transmitting power for Class A stations from 3000 to 6000 Watts, remains under consideration at this time. Final action on that proposal will be taken in a future order. Although also intended to provide for improvement of Class A FM station facilities, that proposal is being considered as an addition, rather than an alternative, to the action taken herein.

29. The Secretary shall send a copy of this *First Report and Order*, including the Final Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 603(a) of the Regulatory Flexibility Act (Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 *et seq.* (1981)).

PAPERWORK REDUCTION ACT STATEMENT

30. The decision contained herein has been analyzed with respect to the Paperwork Reduction Act of 1980, and found to contain modified form requirements. Specifically, minor modifications to FCC Forms 301 and 340, requiring OMB approval, are necessary. However, this decision will not increase or decrease burden hours imposed on the public.

ORDERING CLAUSES

31. Accordingly, IT IS ORDERED That pursuant to the authority contained in Sections 4 and 303 of the Communications Act of 1934, as amended, Part 73 of the Commission's Rules IS AMENDED as set forth in the Appendix, effective **May 18, 1989.**

32. IT IS FURTHER ORDERED That authority is delegated to the Chief, Mass Media Bureau to issue a Public Notice listing the parties subject to reclassification pursuant to this order, and to initially waive Section 73.3566 of the rules (as discussed *supra*, in connection with the "hard look" processing procedures) for applications submitted by these parties.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

APPENDIX A

47 CFR Part 1 is amended as follows:

1. The authority citation for Part 1 continues to read as follows:

Authority: 47 U.S.C. 154 and 303.

2. 47 CFR 1.420 is amended by revising the Note following paragraph (h) to read as follows:

§ 1.420 Additional procedures in proceedings for amendment of the FM, TV or Air-Ground Table of Allotments.

* * * * *

(h) * * *

NOTE: Licensees and permittees operating Class A FM stations who seek to upgrade their facilities to Class B1, B, C3, C2, C1, or C on Channel 221, and whose proposed 1 mV/m signal contours would overlap the Grade B contour of a television station operating on Channel 6 must meet a particularly heavy burden by demonstrating that grants of their upgrade requests are in the public interest. In this regard, the Commission will examine the record in rule making proceedings to determine the availability of existing and potential non-commercial educational service.

47 CFR Part 73 is amended as follows:

1. The authority citation for Part 73 continues to read as follows:

Authority: 47 U.S.C. 154 and 303.

2. 47 CFR 73.207 is amended by revising paragraph (a), the introductory text to paragraph (b) and the text of paragraphs (b)(2), (b)(3), and (c), as follows:

§ 73.207 Minimum distance separation between stations.

(a) Except for assignments made pursuant to §§73.213 or 73.215, FM allotments and assignments must be separated from other allotments and assignments on the same channel (co-channel) and five pairs of adjacent channels by not less than the minimum distances specified in paragraphs (b) and (c) of this section. The Commission will not accept petitions to amend the Table of Allotments, applications for new stations, or applications to change the channel or location of existing assignments unless transmitter sites meet the minimum distance separation requirements of this section, or such applications conform to the requirements of §§73.213 or 73.215. However, applications to modify the facilities of stations with short-spaced antenna locations authorized pursuant to prior waivers of the distance separation requirements may be accepted, provided that such applications propose to maintain or improve that particular spacing deficiency. Class D (secondary) assignments are subject only to the distance separation requirements contained in paragraph (b)(3) of this section. (*See* §73.512 for rules governing the channel and location of Class D (secondary) assignments.)

(b) The distances listed in Tables A, B, and C apply to allotments and assignments on the same channel and each of five pairs of adjacent channels. The five pairs of adjacent channels are the first (200 kHz above and 200 kHz below the channel under consideration), the second (400 kHz above and below), the third (600 kHz above and below), the fifty-third (10.6 MHz above and below), and the fifty-fourth (10.8 MHz above and below). The distances in the Tables apply regardless of whether the proposed station class appears first or second in the "Relation" column of the table.

* * * * *

(2) Under the Canada - United States FM Broadcasting Agreement, domestic U.S. allotments and assignments within 320 kilometers (199 miles) of the common border must be separated from Canadian allotments and assignments by not less than the distances given in Table B, which follows. When applying Table B, U.S. Class C2 allotments and assignments are considered to be Class B; also, U.S. Class C3 allotments and assignments are considered to be Class B1.

* * * * *

(3) Under the Mexico - United States FM Broadcasting Agreement, domestic U.S. allotments and assignments within 320 kilometers (199 miles) of the common border must be separated from Mexican allotments and assignments by not less than the distances given in Table C, which follows. When applying Table C, U.S. Class C2, C3 and B1 allotments and assignments are considered to be Class B; U.S. Class C1 allotments and assignments are considered to be Class C.

* * * * *

(c) The distances listed below apply only to allotments and assignments on Channel 253 (98.5 MHz). The Commission will not accept petitions to amend the Table of Allotments, applications for new stations, or applications to change the channel or location of existing assignments where the following minimum distances (between transmitter sites, in kilometers) from any TV Channel 6 allotment or assignment are not met:

MINIMUM DISTANCE SEPARATION FROM TV CHANNEL 6 (82-88 MHz)

FM Class	TV Zone I	TV Zones II & III
A	16	20
B1	19	23
B	22	26
C3	19	23
C2	22	26
C1	29	33
C	36	41

3. 47 CFR 73.207 is further amended by revising the introductory text in paragraph (b)(1); by adding, in TABLE A in paragraph (b)(1), a new row for relation "A to C3" to be inserted after the existing row for relation "A to B", a new row for relation "B1 to C3" to be inserted after the existing row for relation "B1 to B", a new row for relation "B to C3" to be inserted after the existing row for relation "B to B", and four new rows, for relations "C3 to C3", "C3 to C2", "C3 to C1" and "C3 to C", to be inserted, in that order, after the existing row for relation "B to C", as follows:

§ 73. 207 Minimum distance separation between stations.

* * * * *

(b) * * *

(1) Domestic allotments and assignments must be separated from each other by not less than the distances in Table A which follows:

TABLE A - MINIMUM DISTANCE SEPARATION REQUIREMENTS IN KILOMETERS (MILES)

Relation	Co-channel	200 kHz	400/600 kHz	10.6/10.8 MHz
		* * * * *		
A to C3	138 (86)	84 (52)	42 (26)	12 (8)
		* * * * *		
B1 to C3	175 (109)	114 (71)	50 (31)	14 (9)
		* * * * *		
B to C3	211 (131)	145 (90)	71 (44)	17 (11)
		* * * * *		
C3 to C3	153 (95)	99 (62)	43 (27)	14 (9)
C3 to C2	177 (110)	117 (73)	56 (35)	17 (11)
C3 to C1	211 (131)	144 (90)	76 (47)	24 (15)
C3 to C 237	(147) 176	(109)	96 (60)	31 (19)

* * * * *

4. 47 CFR 73.210 is amended by revising paragra (a), (b)(1), (b)(2), and (b)(3) to read as follows:

§ 73.210 Station classes.

(a) The rules applicable to a particular station, incl ing minimum and maximum facilities requirements, determined by its class. Possible class designations dep upon the zone in which the station's transmitter is cated, or proposed to be located. The zones are defined §73.205. Allotted station classes are indicated in the Ta of Allotments, §73.202. Class A, B1 and B stations may authorized in Zones I and I-A. Class A, C3, C2, C1, an stations may be authorized in Zone II.

(b) The power and antenna height requirements each class are set forth in §73.211. If a station has an E and an antenna HAAT such that it cannot be classif using the maximum limits and minimum requirement §73.211, its class shall be determined using the follow procedure:

(1) Determine the reference distance of the stat using the procedure in paragraph (b)(1)(i) of §73.211 this distance is less than or equal to 24 km, the statio Class A; otherwise,

(2) For a station in Zone I or Zone I-A, except Puerto Rico and the Virgin Islands:

(i) If this distance is greater than 24 km and less t or equal to 39 km, the station is Class B1.

(ii) If this distance is greater than 39 km and less t or equal to 52 km, the station is Class B.

(3) For a station in Zone II:

(i) If this distance is greater than 24 km and less t or equal to 39 km, the station is Class C3.

(ii) If this distance is greater than 39 km and less than or equal to 52 km, the station is Class C2.

(iii) If this distance is greater than 52 km and less than or equal to 72 km, the station is Class C1.

(iv) If this distance is greater than 72 km and less than or equal to 92 km, the station is Class C.

* * * * *

5. 47 CFR 73.211 is amended by revising paragraphs (a)(1), (a)(2), the table in the introductory text of paragraph (b)(1), and paragraph (b)(3), to read as follows:

§ 73.211 Power and antenna height requirements.

(a) *Minimum requirements.* (1) Except as provided in paragraphs (a)(3) and (b)(2) of this section, FM stations must operate with a minimum effective radiated power (ERP) as follows:

(i) The minimum ERP for Class A stations is 0.1 kW.

(ii) The ERP for Class B1 stations must exceed 3 kW.

(iii) The ERP for Class B stations must exceed 25 kW.

(iv) The ERP for Class C3 stations must exceed 3 kW.

(v) The ERP for Class C2 stations must exceed 25 kW.

(vi) The ERP for Class C1 stations must exceed 50 kW.

(vii) The minimum ERP for Class C stations is 100 kW.

(2) Class C stations must have an antenna height above average terrain (HAAT) of at least 300 meters (984 feet). No minimum HAAT is specified for Classes A, B1, B, C3, C2, or C1 stations.

* * * * *

(b) *Maximum limits.* (1) Except for stations located in Puerto Rico or the Virgin Islands, the maximum ERP in any direction, reference HAAT, and distance to the class contour for each FM station class are listed below:

Station Class	Maximum ERP	Reference HAAT in meters (ft)	Class contour distance in kilometers
A	3kW (4.8 dBk)	100 (328)	24
B1	25kW (14.0 dBk)	100 (328)	39
B	50kW (17.0 dBk)	150 (492)	52
C3	25kW (14.0 dBk)	100 (328)	39
C2	50kW (17.0 dBk)	150 (492)	52
C1	100kW (20.0 dBk)	299 (981)	72
C	100kW (20.0 dBk)	600 (1968)	92

* * * * *

(3) For stations located in Puerto Rico or the Virgin Islands, the maximum ERP in any direction, reference HAAT, and distance to the class contour for each FM station class are listed below:

Station Class	Maximum ERP	Reference HAAT in meters (ft)	Class contour distance in kilometers
A	3kW (4.8 dBk)	335 (1100)	42
B1	25kW (14.0 dBk)	150 (492)	46
B	50kW (17.0 dBk)	472 (1549)	78

* * * * *

6. 47 CFR 73.506 is amended by revising paragraph (a)(3) to read as follows:

§ 73.506 Classes of noncommercial educational FM stations and channels.

(a) * * *

(3) Noncommercial educational FM (NCE-FM) stations with more than 10 watts transmitter power output are classified as Class A, B1, B, C3, C2, C1, or C depending on the station's effective radiated power and antenna height above average terrain, and on the zone in which the station's transmitter is located, on the same basis as set forth in §§73.210 and 73.211 for commercial stations.

* * * * *

7. 47 CFR 73.610 is amended by revising paragraph (f) to read as follows:

§ 73.610 Minimum distance separations between stations.

* * * * *

(f) The distances listed below apply only to allotments and assignments on Channel 6 (82-88 MHz). The Commission will not accept petitions to amend the Table of Allotments, applications for new stations, or applications to change the channel or location of existing assignments

where the following minimum distances (between transmitter sites, in kilometers) from any FM Channel 253 allotment or assignment are not met:

MINIMUM DISTANCE SEPARATION FROM FM CHANNEL 253 (98.5 MHz)

FM Class	TV Zone I	TV Zones II & III
A	16	20
B1	19	23
B	22	26
C3	19	23
C2	22	26
C1	29	33
C	36	41

APPENDIX B

List of parties filing formal comments

Advance Broadcasting Corporation (WGNY)

Aiken Communications Corp. (WGBF) *

Albany Broadcasting, Inc. (WQBK) *

The Alpha Group (KXMK) *

Jose J. Arzuaga (WREI)

Association for Broadcast Engineering Standards, Inc. *

Association of Federal Communications Consulting Engineers *

Baker Broadcasters, Inc. (WBZI) and State Line Radio (joint) *

Barry Broadcasting Company (WBCH)

Bay Communications, Inc. (WCME) *

Randolph V. Bell

Bonneville International Corporation (7 FM stations)

Albert L. Crain/Ouachita Communications, Inc. (joint) *

Creative Broadcasters, Inc.

The Cromwell Group, Inc. *

deHaro Radio, Ltd. *

Dettra Broadcasting (WQRA)

Draper Communications, Inc. (WLGQ), Edenton Broadcasting Corporation (WZBO), WWGP Broadcasting Corporation (WFJA), Muirfield Broadcasting, Inc. (WIOZ), Great American Media, Ltd. I (WYNA), Hi-Toms Broadcasting, Inc. (WTHP), WOBR, Inc. (WOBR), Blacksburg-Christiansburg Broadcasting Company (WVVV), Garden City Broadcasting Company (WORG), Voyager Communications III, Inc. (WLWZ), Florence County Broadcasting Company (WGFG), Piedmont-Crescent Communications, Inc. (WABZ), Pro-Media, Inc. (WZYZ) and Jennings Communications Corporation (WDZD) (joint)

Drexel Hill Associates, Inc. (WIIS,WDHA)

du Treil, Lundin & Rackley, Inc. *

E. Harold Munn, Jr. & Associates, Inc. *

Equus Broadcasting, Inc. (WVLI) *

FM 105, Inc. (WZZT) *

Fairmont Broadcasting Company *

Fernbrook Broadcasting Corporation (WKHV) *

Fuller-Jeffrey Broadcasting Companies, Inc. *

Gannett Co., Inc. (9 FM stations)

Golden West Broadcasters (KMPC) *

Great American Television and Radio Company, Inc. (8 FM stations) *

Greater Media, Inc. (7 FM stations) *

Hoffman Media of Louisiana (WQCK) *

JAB Broadcasting (WDLT) *

Jarad Broadcasting Company, Inc. (WDRE)

The Jet Broadcasting Co., Inc. (WJET)

KISS Limited Partnership *

KPHN, WGRG, KJFK, KCMJ, WIQQ, KTZA, WWKF (joint) *

Karl D. Lahm, P.E. *

Lake Cities Broadcasting Corporation (WLKI)

Main Street Broadcasting Company, Inc. (WLNG)

Maines Broadcasting, Inc. (WMRX)

Malrite Radio and Television, Inc. (KZLA) *

Keith Mason (WSSQ)

Robert M. Mason

Massachusetts Class A Broadcasters Association

Aurio Matos (WRFE) and Seashore Broadcasting Corporation (WOBM) (joint)

Mechanicsville Community Broadcasting Company (WQMR)

Mississippi College (WHJT) *

Montbrook Broadcasting, Ltd. *

Mountain Broadcasting Co., Inc. (KTOT)

National Association of Broadcasters *

National Public Radio and Corporation for Public Broadcasting (joint) *

New Jersey Broadcasters Association

New Jersey Class A FM Broadcasters Association *

Newcity Communications, Inc. (9 FM stations) *

Northeast Communications Corporation (WFTN)

Nutmeg Broadcasting Company (WILI)

Pepper & Corrazzini *

Pleasant Broadcasters (WADB)

Power Du Pree Broadcasting Company / J and J Broadcasting (joint)

Premier Broadcast Group of Lexington, Inc. (WFMI)

Premier Broadcast Group, Inc. (WKLI)

Pulaski County Broadcasters, Inc. (KJPW)

R-B Company, Inc. (WRRL)

Radio Musical, Inc. (WBRQ)

Reynolds Communications, Inc. (WSUL)

Sanilac Broadcasting Company (WTGV) *

Scripps Howard Broadcasting Company (3 FM stations) *

C. Curtis Sigmon (WDZK) *

Southernwood Media Corporation (WCTD)

Southwest Ohio Broadcast Service General Partnership (WSWO)

Stoner Broadcasting System, Inc. (WCMF, WWSN, WYRK, WHWK)

Susquehanna Radio Corp. (11 FM stations) *

T.G.S. Communications, Inc. (KMOQ) *

3-D Communications Corporation (WDDD)

Tri-Valley Broadcasting Corporation (WMJV)

Universal Broadcasting Corporation (WCBW, WSYW, WVVX, KMAX) *

Vacationland Broadcasting Services

Viacom Broadcasting, Inc. (6 FM stations) *

Virden Broadcasting Corp. (WRVI)

WJER Radio, Inc. (WJER) *

WN Broadcasting (WNCD)

Westinghouse Broadcasting Company, Inc. (7 FM stations) *

Willis Broadcasting Corporation (5 FM stations) *

The Wireless Group, Inc. (WTBG, WLOT)

* denotes parties addressing issues relating to the proposed station Class C3

List of parties filing formal replies

Bay Communications, Inc. (WCME) *

CBS, Inc.

Ethnic Radio, Inc. (KATD)

Greater Media, Inc. *

The Hearst Corporation (WIYY, WLTQ, WHTX)

Main Street Broadcasting Company, Inc. (WLNG)

Maines Broadcasting, Inc. (WMRX)

Massachusetts Class A Broadcasters Association

National Association of Broadcasters *

Nelson Enterprises, Inc.

New Jersey Class A FM Broadcasters Association

Premier Broadcast Group

Radio Broadcasters, Inc. (KSRF)

Universal Broadcasting Corporation (WCBW, WSYW, WVVX, KMAX)

Willis Broadcasting Corporation (WPDQ, KFTH, WKWQ, WWPD, WSFU)

* denotes parties addressing issues relating to the proposed station Class C3

List of parties submitting letters included in the file

Alexandra-Brooke Broadcasting, Inc. (WCRQ)

Vernon R. Baldwin (WZLE)

Betap Broadcasting, Inc. (WAEY)

James G. Bethard (KRRP)

Ann H. Bignell (WHMI)

Honorable Robert M. Blais, Mayor, Village of Lake George, NY

Brattleboro Broadcasters, Inc. (WKVT)

Honorable John Breaux, United States Senator

Joseph L. Bruno, State Senator, New York

Buckley Broadcasting Corporation (WYNZ), (KGIL)

Honorable Dale Bumpers, United States Senator

CRS Communications, Inc. (WXYU)

Capitol Broadcasting Corporation, Inc. (WKXL)

Carter County Broadcasting Company, Inc. (WUGO)

Jeffrey Chandler (KKOS)

Robert Channick (WCCQ)

Kathryn Cheap (WQRK)

Tony Childress

Clear Communications, Inc. (WVLT)

Commonwealth Broadcasting of Arizona, Inc. (KYXI)

Richard L. Cornell (WSAL)

Honorable Lawrence Coughlin, Member, U.S. House of Representatives

Covered Bridge Broadcasting, Ltd. (WAXI)

Covington County Broadcasters, Inc. (WKNZ)

Cumberland Valley Broadcasting Co., Inc. (WTRZ)

James R. Curtis, Jr. (KAEZ)

D & M Broadcasting, Inc. (WOMA)

Jack F. Daly (WJTW)

DeFuniak Communications, Inc. (WNOX) (WQUH)

Dearbour County Broadcasters, Inc. (WSCA)

Dickerson Broadcasting, Inc. (WEAG)

Ken Diebel (KTJC)

Tom E. Donnelly (KYOC)

Honorable Richard J. Durbin, Member, U.S. House of Representatives

William P. Eaton, Jr. (WSCZ)

Edenton Broadcasting Corporation (WZBO)

Ian Epstein (KHAZ)

Fairfield Broadcasting Company (WQLR)

Honorable Hugh T. Farley, State Senator, New York

Amos F. Finch (WDLA)

Honorable Hamilton Fish, Jr., Member, U.S. House of Representatives

Floyd County Broadcasting (WMDJ)

Honorable Wendell H. Ford, United States Senator

Fort Bend Broadcasting Company, Inc. (KFRD)

Fox Broadcasting Company (WLBF)

Franklin Broadcasting Company (KFMV)

GBS Communications, Inc. (WWIZ)

James J. Gamley, Scott Goodwin (WWWY)

Ray Garon (KIXX)

Honorable Sam Gejdenson, Member, U.S. House of Representatives

Douglas W. George (WHTF)

Gillen Broadcasting Corporation (WYKS)

Honorable Benjamin A. Gilman, Member, U.S. House of Representatives

Eaton P. Goran, III (WUSJ)

Larry Graf (KKJR)

Honorable Bill Grant, Member, U.S. House of Representatives

L. Gene Gray (WRQR)

Dan Greer (WDZZ)

Kelly Guglielmi (WGNY)

Guntersville Broadcasting Company (WGSV)

Honorable Lee H. Hamilton, Member, U.S. House of Representatives

Hanson Communications, Inc. (WGMX)

Honorable Glen H. Harris, Member, New York State Assembly

Honorable Jesse Helms, United States Senator

Lora Holdman (WQRK)

Idabel Broadcasting Company (KWDG)

Impact Broadcasting, Inc. (WXCF)

Indiana Broadcasters Association, Inc.

Staci Jennings (WQRK)

Jersey Shore Broadcasting Corporation (WJRZ)

Honorable J. Bennett Johnston, United States Senator

Jacqueline A. Joseph (WLKQ)

Honorable Neil W. Kelleher, Member, New York State Assembly

John Kennedy (WGEL)

William B. Klaus (WNIR)

Paul Knies (WBDC,WORX)

LaFollette Broadcasters, Inc. (WQLA)

Lane Broadcasting Corporation (WWDL)

Andrew A. Langston (WDKX)

Bruce D. Law (WKTU)

Sylvia B. Levtz (KKBN)

Cassandra Livingston (WYYS)

Teresa Luttrell (WOKZ)

Robert J. Maley (WEAY)

Manitou Broadcasting Corp. (WROI)

Marshfield Broadcasting Company, Inc. (WATD)

Honorable Jim McCrery, Member, U.S. House of Representatives

Robert M. McKay, Jr. (WKOM)

Media Capital, Inc.

Honorable Henry J. Mello, State Senator, California

Honorable Robert H. Michel, Member, U.S. House of Representatives

Steve Mickelson (KNIM)

Dean Miller (WMVR)

Honorable Ronald S. Montesi, Councilman, Town of Queensbury, NY

Karl F. Moore (WQRK)

Joseph Nardone (WTLQ)

New South Radio, Inc. (WACT)

Honorable Don Nickles, United States Senator

Normandy Broadcasting Corporation (WYLR)

Northampton Broadcasting Corp. (WHMP)

Odon Communications Group I (WAHC)

Ohio Broadcast Stations, Inc. (WJMR)

Ohio Broadcast Consultants, Inc./Christian Voice of Central Ohio (WCVO,WCVZ)

Robert F. Ottaway (WMMQ)

Walter H. Parker (WSKV)

Jim Parman (WRNZ)

C. R. Pasquier Properties, Inc. (KOCN)

Roger P. Pasquier (KOCN)

Jeffrey A. Pence (WKJM)

Frank E. Penny (WQXT)

Honorable Carl C. Perkins, Member, U.S. House of Representatives

Phillips Broadcasting Company, Inc. (WMEQ)

James B. Pidcock (WBBY)

Port Jervis Broadcasting Co., Inc. (WTSX)

Honorable David Pryor, United States Senator

Pulaski Broadcasting, Inc. (WKSR)

Q102 Broadcasting Company

Quaker State Broadcasting Corporation (WTPA)

Quality Broadcasting, Inc. of Georgia and Tenessee (WQXM), (QZDQ)

Quantum Broadcasting Corp. (WRCR)

Radio Mid-Pom, Inc. (WMPO)

Radio South Burlington, Inc.

The RadioActive Group

William O. Reelfs (KSYV)

Reynolds Communications, Inc. (WSUL)

John C. Rice (KTOI)

Rollings Communications of Illinois (WZNF)

Joe Rosa (KATD)

Edd Routt (KCKL)

Dennis W. Rumsey (WLKM)

Russell Broadcasting, Inc. (WMDK)
SSS Communications, Inc. (KYNZ)
Sage Broadcasting Corporation (WSGD)
Larry E. Salsburey (KQEZ)
Angelo Joseph Salvi (WLUV)
John W. Schuler (WSCH)
Jerry Shepard (WSSV)
J. Douglas Sherfield (WQRK)
Ralph Sherman (WLLI)
Shoreline Communications, Inc. (WVVE)
George C. Shurden, Sr. (WCLD)
Jack L. Siegal
Max E. Smith, Sr. (WHFD)
Sound Alternative, Inc. (WVLJ)
William G. Stallard (WNVA)
Donald C. Steese (WOEZ)
Sunrise Broadcasting Co., Ltd. (KRPQ)
Joel K. Swartz (KATD)
Robert B. Taylor (WXKE)
Tennessee River Broadcasting, Inc. (WKWX)
Honorable Louis Tessier, Supervisor, Town of Lake George, NY (WRGC)
Honorable William M Thomas, Member, U.S. House of Representatives
Honorable Strom Thurmond, United States Senator
Tift Area Radio, Inc. (WJYF)
Annice H. Trevitt (WQMT)
Trinity Broadcasting Corp. (KBCE)
Tuscarawas Broadcasting Company (WNPQ)
U.S. Three Broadcasting Corp. (WKSY)
Steven F. Udvar-Hazy
United Broadcasting Company, Inc. (WWVR)
Uno Broadcasting Corporation (WLLI)
Phillip G. Vessey (WDLA)
Vidalia Communications Corporation (WTCQ)
Video Communications & Radio, Inc.
Honorable Mijo Vonic, Supervisor, Town of Kingsbury, NY
WDNH Broadcasting Corporation (WDNH)
WJXR, Inc. (WJXR)
Warren Broadcasting Company, Inc. (WMCR)
Honorable Wes Watkins, Member, U.S. House of Representatives
Bradley M. Weeks (WBFL)
Weiner Broadcasting, Inc. (WUPE)
Richard C. Weis (WFPS)
Richard White (WFAS)
Theresa Wiegand-Swihart (WQRK)
Wilderness Hills Broadcasting, Inc. (WWXL)
Honorable Pete Wilson, United States Senator
Wilson County Broadcasting Company (KWCB)
David L. Winchester (WBEC)
Winn Broadcasting Company (KVCL)
Scott A. Young (WTGN)
John A. Zanzarella (WZFM)
Robert K. Zimmerman (WQWK)

Note: Many other parties submitted letters before, during and after the comment periods. These letters, although not inserted in the docket file, were read by the staff and the viewpoints contained therein will be taken into consideration throughout this proceeding.

FOOTNOTES

[1] *See Notice of Proposed Rule Making* in MM Docket 88-375, FCC 88-251, released on September 12, 1988, 3 FCC Record 5941 (1988).

[2] The zones are defined in §73.205 of the Commission's rules. Zone I is a large area in the northeastern portion of the United States, containing the District of Columbia, the states of Indiana, Illinois, Pennsylvania, Ohio, West Virginia, Maryland, Delaware, Massachusetts, Connecticut, and portions of Michigan, Wisconsin, New York, Maine, New Hampshire, Vermont and Virginia. Zone I-A contains Puerto Rico, the U.S. Virgin Islands, and all but the northernmost portion of California. Zone II contains Alaska, Hawaii, and the rest of the continental United States not in Zones I and I-A.

[3] The Commission proposed that this limit be raised from 3000 to 6000 Watts effective radiated power.

[4] E. Harold Munn, Jr. and Associates, Inc., and Pepper & Corazzini, in comments, and Bay Communications, Inc., in reply, all suggest that the Commission decide the Class C3 proposal first and separately from the Class A power limit increase proposal, for the reasons given.

[5] *See Notice*, 3 FCC Rcd at 5943, para. 21.

[6] *See id*, para. 22. The Petaz petition recommended that the somewhat larger distances applicable to FM Class B1 in Zones I and I-A be used for Class C3. However, this view was disputed by others initially commenting on the Petaz petition because it would create inconsistent and illogical spacing requirements among the various station classes in Zone II.

[7] *See Further Notice of Proposed Rule Making* in MM Docket 86-144, FCC 88-87, 3 FCC Rcd 1661 (1988). Noting that the IF distance separation requirements for FM broadcast stations provided different levels of protection depending on the classes of stations involved, and that there was no technical justification for this disparate treatment, the Commission proposed to revise the required minimum IF separation distances to provide a uniform level of protection from IF interference. The proposed revisions were adopted by the Commission on February 15, 1989. *See* footnote 24, *infra*. The IF distance separation requirements are contained in §73.207 of the Commission's Rules.

[8] *See Notice* 3 FCC Rcd at 5943 and 5945, paras. 23 and 41.

[9] Also, an informal letter comment was received from Robert K. Zimmerman, of station WQWK, in opposition to all of the proposals for improvement of Class A stations, including the Class C3 proposal. Mr. Zimmerman's letter requested that the Commission leave the FM rules unchanged, and expressed the opinion that there are too many FM stations now and that no more should be licensed.

[10] *See* comments of Crain/Ouachita at page 3, paragraph 4.

[11] *See* comments of Greater Media at page 6, paragraph 8.

[12] *See* comments of Alpha at page 10, paragraph 21.

[13] *See* comments of Munn at 2.

[14] *Id.* at 1.

[15] NPR/CPB also opposes the proposed Class A power increase, for the same reasons.

[16] *See* comments of NPR/CPB at 1. In BC Docket 20735, the Commission adopted rules (*see* §73.525) that provide for protection of Channel 6 TV reception from interference by non-commercial educational FM stations.

[17] NPR/CPB cites the Commission's actions in BC Docket 80-90, which resulted in the allotment of approximately 700 new stations nationwide, and MM Docket 86-144, which, among other things, allowed Class A stations to upgrade to a higher class without having to change frequency.

[18] *Id.* at 7-9.

[19] *See* comments of Susquehanna at 2.

[20] *See* comments of Greater Media at page 5, paragraph 6.

[21] *See* comments of dLR at 2-3. *See also* comments of Lahm at page 3, paragraph 5.

[22] *See* 2 FCC Rcd 660 (1987) at paragraph 12. The Commission stated the policy that, where the Grade B contour of a Channel 6 TV station and the 1 mV/m signal contour of a proposed upgraded facility on FM Channel 221 would overlap, the petitioner of such facility would have a particularly heavy burden to demonstrate that a grant of its request to upgrade is in the public interest. In such situations, the Commission will examine the record to determine the availability of existing and potential non-commercial educational FM service. *See also* the Note following §1.420 of the Commission's Rules, and the revision thereto in Appendix A. The Commission's staff has recently provided additional guidance to petitioners preparing engineering studies designed to meet the "heavy burden" policy. *See Myrtle Beach, SC*, 3 FCC Rcd 7269 (Mass Media Bur. 1988).

[23] The station classes available in Zone II, after the effective date of the Commission's action herein, will be as follows:

	CLASS A	CLASS C3	CLASS C2	CLASS C1	CLASS C
Maximum ERP	3 kW	25 kW	50 kW	100 kW	100 kW
Reference HAAT	100 m	100 m	150 m	299 m	600 m
Coverage					
city (70 dBu)					
radius	13.5 km 8.4 mi	23.2 km 14.4 mi	32.6 km 20.3 mi	50.0 km 31.1 mi	67.7 km 42.1 mi
area	573 km^2 222 mi^2	1691 km^2 651 mi^2	3339 km^2 1295 mi^2	7854 km^2 3039 mi^2	14399 km^2 5568 mi^2
service (60 dBu)					
radius	24.2 km 15.0 mi	39.1 km 24.3 mi	52.2 km 32.4 mi	72.3 km 44.9 mi	91.8 km 57.0 mi
area	1840 km^2 707 mi^2	4803 km^2 1855 mi^2	8560 km^2 3298 mi^2	16422 km^2 6333 mi^2	26475 km^2 10207 mi^2

[24] *See Third Report and Order* in MM Docket 86-144, FCC 89-62, _____ FCC Rcd _____ (1989). The Commission determined that its IF distance separation requirements should be based on a uniform level of protection from IF interference. Accordingly, the distances were adjusted as necessary to prevent overlap of the predicted 36 mV/m contours of IF related stations, regardless of the station classes involved.

[25] *See Report and Order*, BC Docket 80-90, 94 FCC 2d 152 (1983); *recon., granted in part and denied in part*, 97 FCC 2d 279 (1984); *rev'd in part sub nom., Reeder v. FCC*, 865 F.2d 1298 (1989). In the *Report and Order*, paragraphs 63-70.

[26] A tentative list of these licensees and other parties (applicants and permittees) that may potentially be reclassified is given in Appendix C.

[27] The Commission will issue a Public Notice listing these parties based on their status on the effective date of this order.

[28] The FM "hard look" processing rules were adopted in the *Report and Order* in MM Docket 84-750, FCC 85-125, 58 RR 2d 776 (1985), 50 FR 19936 (May 13, 1985).

[29] *See Notice* at paragraph 38.

[30] *See Public Notice* "Mass Media Bureau to Propose Upgrades on its Own Motion", March 31, 1989, for a tentative list of these stations.

[31] The Table of FM Allotments is contained in §73.202 of the Commission's Rules.

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Revisions to the Average
Schedules Proposed by NECA
on October 3, 1988

MEMORANDUM OPINION AND ORDER

Adopted: March 29, 1989; Released: March 31, 1989

By the Chief, Common Carrier Bureau:

I. INTRODUCTION

1. On October 3, 1988, the National Exchange Carrier Association (NECA) proposed revisions to the interstate average schedules. The revisions were filed in response to our Order released December 21, 1987 (the 1987 Order) that declined to accept proposed revisions to the average schedules filed by NECA on June 30, 1987.[1] The 1987 Order provided certain corrective guidelines and directed NECA to refile proposed revisions consistent with those guidelines.[2] Eight parties filed comments on NECA's proposed revisions, two parties filed informal comments, and seven parties filed reply comments.[3] In this Order, we approve NECA's proposed revisions to the average schedules, effective April 1, 1989, subject to the conditions discussed below.

II. BACKGROUND

2. Our access rules govern the compensation received by local exchange carriers (LECs) for the use of their networks in originating and terminating interstate calls. This compensation is determined through the application of regulations governing the apportionment of LEC investment and expense to regulated activities, jurisdictional separations (dividing the investment and expense in each of the accounts between the interstate and intrastate jurisdictions), and cost allocation (apportioning the interstate share of each account to various access elements for ratemaking purposes). This process requires the preparation by the LECs of "cost studies," which involve significant data collection, analysis, reporting, and auditing. The larger LECs have the expertise and other resources to perform these studies efficiently, and their interstate revenue requirements are so large that considerable precision in determining the costs on which their interstate rates are based is clearly warranted. Smaller LECs, on the other hand, may not have the expertise or other resources in-house to perform these studies and may have to hire outside consultants at substantial expense, especially compared to the relatively small size of the interstate compensation they receive. The Commission's rules recognize that it may be inefficient to require cost studies in all cases and, accordingly, permit certain LECs to receive interstate settlements on the basis of a set of "average schedules" that are "designed to produce disbursements to an average schedule company that simulate the disbursements that would be received . . . by a [cost study] company that is representative of average schedule companies."[4] This procedure has the advantage of substantially reducing the costs that are imposed upon small exchange carriers in determining their compensation for interstate services, with the concomitant benefit to the public of reducing the expenses of accounting and separations studies that otherwise would have to borne, in part, by interstate ratepayers.

3. The most recent set of average schedule revisions that were approved by the Commission became effective June 1, 1986, and have remained in effect since then.[5] As noted above, NECA filed proposed revisions to the average schedules in 1987, which we rejected in the 1987 Order. That order found that cost companies had been required to implement five changes affecting their interstate access settlements that were not adequately reflected in the proposed revisions. Those changes included a revised system of accounts in Part 32 of our rules, a revised separations manual in Part 36 of our rules, revised cost allocation requirements established in CC Docket No. 86-111, revised access charge rules in Part 69 of our rules reflecting changes to the Part 32 and 36 accounting and separation rules,[6] and reductions in tax expenses resulting from the enactment of the Tax Reform Act of 1986. Accordingly, the 1987 Order directed NECA "to propose corresponding revisions to the average schedules. . . that demonstrate that relevant effects of Parts 32, 36, and 69 changes, the Joint Cost rules, and the Tax Reform Act of 1986 have been accurately reflected in its computations."[7]

4. The 1987 Order also directed NECA to address certain issues related to its proposal to modify the treatment of Carrier Access Billing (CABS) settlements and Access Administrative Cost (Administrative Expense) under the average schedules. Specifically, we directed NECA to "take cognizance of, and test, additional functional forms that explore the relationship between the base, or fixed, component of CABS and Administrative Expenses and total CABS and Administrative Expenses."[8] Finally, we required NECA "to complete its sampling of requisite data during 1988" and "to perform those computations that are necessary to simulate the disbursements that would be received pursuant to § 69.607 by a company that is representative of average schedule companies".[9]

III. OVERVIEW OF NECA FILING

A. *Description of NECA Filing*

5. NECA states that its proposed revisions are based on a newly completed statistical sample of cost and average schedule companies that reflect updated data and comply with the Commission rule requiring that the average schedules simulate the disbursements received by comparable cost companies.[10] NECA states that it revised the average schedules, as we required in the 1987 Order, to adjust for the Tax Reform Act of 1986, the adoption of a new Part 32 Uniform System of Accounts (USOA), new Part 36 Separations procedures, USOA conformance changes, new rate base rules, and the joint cost rules. NECA also states that it has adopted a new formula structure for the reimbursement of CABS and access administration costs that is consistent with the 1987 order.[11]

6. NECA contends that since June 1986, when its last revisions became effective, "significant industry changes have resulted in a shift in cost recovery away from the interstate jurisdiction, including the phase down to the 25% gross allocator for non traffic sensitive plant, detariffing of inside wire, and detariffing of CPE".[12] The cumulative effect of these industry changes, reflected in the revised average schedules, will result in a total annual settlement reduction of about $49 million, or an overall 10.5% reduction in average schedule settlements.[13] NECA has determined that this reduction in settlements should be phased in over a two-year period, with only those companies that are most severely affected receiving transition payments for the full two-year period. Although actual settlements will be reduced under the proposed revisions, NECA found that data from its new sample generally confirmed the accuracy of the structure of its underlying average schedule formulas. However, NECA proposes a new distance-sensitive line haul facility formula based on new statistical data.[14]

B. ***Positions of the Parties***

7. Commenters representing the vast majority of affected parties endorse NECA's proposed revisions. USTA, which represents local exchange carriers providing 99% of the access lines in the country, supports the revisions, stating that the proposed average schedule revisions are based on increased statistical support and accurately reflect industry changes.[15] NTCA, a national association of 450 small rural LECs, many of whom are average schedule companies, supports "expeditious" approval of the revisions.[16] NTCA states that the latest revisions "represent a major stride in further improving the process", and cites specific advancement in mechanization and standardization of data gathering, larger data bases, and useful industry participation.[17] OPASTCO, a national trade association of 360 independently owned rural telephone companies, also supports the revisions although OPASTCO average schedule companies will receive less revenue under the plan.[18] Two other average schedule companies, Shenandoah and Union Springs, support the proposed revisions. Shenandoah states that the decrease in revenues for average schedule companies is "appropriate,"[19] and Union Springs states that it expects a "minimal" impact on its operations as a result of the proposed changes.[20] In addition the Iowa Telephone Association, the Minnesota Telephone Association, ALLTEL, and Telephone and Data Systems support the revisions.[21]

8. In contrast, only one average schedule company, Consolidated, challenges certain aspects of the proposed revisions. Consolidated asserts that it stands to lose 36.59% in average schedule settlements under the proposed revisions and challenges the adequacy of the proposed transition plan and line haul formula.[22] ICORE, a consulting firm, also challenges the proposed revisions.[23] It states that the proposed revisions contain the same methodological flaws that ICORE has alleged in proceedings relating to previous revisions in the average schedules, and challenges the Common Line formula, the new Line Haul formula, and the the proposed transition plan.[24]

C. ***Discussion***

9. The record reflects almost unanimous support for the proposed revisions. Parties commend improvements to NECA procedures and state that the revisions reflect the industry changes that this Commission directed. The proposed revisions merit support even from parties that face a reduction of revenue if the revisions are accepted. As discussed below, we agree with the majority of commenters that the proposed revisions are an improvement over the existing schedules and should take effect immediately. However, one company, Consolidated, is disproportionately affected by the proposed revisions, and we direct NECA to modify its proposed transition plan to ensure that Conslidated does not face settlement reductions during the transition period significantly greater than other companies.[25] We address these and other specific issues following a review of the methodology NECA used to develop its new settlement procedures.

IV. OVERVIEW OF THE NECA METHODOLOGY

10. The analytical and statistical work undertaken by NECA in developing a new system of payments for average schedule companies was extraordinarily complicated. In this section we summarize the methodology used by NECA to develop the proposed settlement formulas. In the next section, we examine several more specific issues dealing with CABS, the conformance changes we have directed NECA to make, and the specific formulas NECA developed for the settlement of line haul and common line costs.

11. Broadly speaking, the task of developing a fair system of average schedule payments is not unlike the task faced by a taxing authority in seeking to develop a fair schedule of standard deductions for taxpayers who, for one reason or another, do not keep financial records that would allow them to compute their actual deductions. Conceptually, two approaches can be taken. First, the taxing authority can study the expenditures of those individuals who keep detailed records but who otherwise resemble taxpayers who do not keep records. Alternatively, the taxing authority could select a sample of taxpayers who do not keep records and attempt to reconstruct their records and what their actual deductions might have been if they had kept records. Neither approach is perfect. The expenditure patterns of those who keep records may somehow differ from those who do not (even if they otherwise "look alike" in all measurable respects), and the reconstruction of records is difficult, burdensome, and likely to be inaccurate.

12. The problem of developing average schedules is also like that of developing standard deductions in that no schedule can be expected to fit all companies perfectly. At best, it can provide a "fair" means of compensating companies that are more or less typical. A schedule designed to fit the unique needs of every company would be so complex and cumbersome that the advantages of a simple average schedule would be lost. Companies with unique or special situations may find that the use of an average schedule is not in their best interest--just as many taxpayers find that itemizing deductions is more advantageous than taking a standard deduction. Hence, the appropriate measure of an average schedule is not whether it perfectly compensates each and every company, but whether, on balance, it is a fair and reasonable approximation of what typical companies that do not keep detailed records might receive if they did keep such records.[26]

13. As we shall see, the methodology used by NECA employs elements of both of the basic approaches outlined above. NECA's analysis can be divided essentially into two stages. The first was that leading up to the development of the data presented in Appendix G of its filing--the estimated 1989 revenue requirements for major access categories (common line, transport, central office, and special access) for each of 121 average schedule companies.[27] The second stage of the analysis used that data to develop the average schedule formulas that specify the compensation that average schedule companies receive for their interstate costs. Because the development of estimated 1989 revenue requirements reported in Appendix G was only one step in a lengthy and complicated series of computations, we do not wish to overemphasize the importance of that particular set of data. Nevertheless, the development of Appendix G data represents a convenient point for dividing the analysis undertaken by NECA into two stages, and we will discuss each of these two stages separately.

14. The first stage of NECA's analysis was perhaps the most complicated. It began by drawing two stratified random samples -- one sample of companies that use average schedules and one of "look alike" companies that perform the necessary studies to settle their accounts on the basis of actual costs. Extensive demand and cost information was collected from each company in both samples. The rationale for both samples and the sampling methodology is adequately described in NECA's filing and has not been challenged -- other than the general concern about the "look alike" process discussed below.

15. Companies in both samples were able to provide "demand information" (i.e., information on their number of access lines, exchanges, route miles, and minutes of traffic). While average schedule companies keep records of investments and expenses (for example, maintenance, depreciation, and the like), those companies do not "separate" their costs between intrastate costs and interstate costs. Full information on costs allocated to the interstate jurisdiction is available only from those companies that actually undertake the necessary "cost studies". Average schedule companies are not required to undertake such studies and accordingly cannot be expected to have such information available.

16. Having collected the necessary data, NECA's first created the allocation factor models shown in Exhibit 4.36.[28] Each model is a series of equations--based on the data of the "look alike" cost companies --designed to translate recorded expenses into interstate cost allocations. NECA applied this model to each company in the sample of average schedule companies, to generate the Appendix G data. This data, for each company in the sample of average schedule companies, shows what its estimated 1989 allocation to the interstate jurisdiction would have been (prior to certain recent rule changes) if it allocated expenses in the same manner as the "look alike" cost companies.

17. The first stage of NECA's analysis is the least controversial. The only objection is presented by ICORE, which argues that NECA's "'look alike' process is still devoid of any demonstrated relationship between cost company allocations and the average schedule company allocations for which the cost data is supposedly a surrogate."[29] In ICORE's view, "NECA has no separations allocation data for any of its average schedule companies, neither traffic holding time studies nor annualized factors. NECA obviously cannot relate average schedule company characteristics to average schedule company allocations when it has no allocation data. Neither has NECA performed any studies to investigate what characteristics are determinate of cost company allocations. Given this complete lack of data and studies, it is impossible for NECA to match cost companies to average schedule companies in terms of interstate allocations."[30] ICORE concludes that "NECA's 'look alike' process is thus no more than a 'shot in the dark' which provides no assurance that average schedule company investment, expense and related data are being allocated to interstate access in any representative manner."[31]

18. ICORE's allegation that NECA did not perform "any studies to investigate what characteristics are determinate of cost company allocations" is simply inaccurate. Indeed, the very purpose of developing allocation factor models was to examine factors that determined cost company allocations.

19. As indicated at the outset, the generic problem in developing average schedules is how to acquire information about the allocations that average schedule companies *would* have made *if* they kept the records to do so. Clearly, if average schedule companies performed the cost studies necessary to provide "average schedule allocation data", there would be no need for the use of average schedules in the first place. Also as indicated at the outset, there are two basic approaches to dealing with this problem -- sampling "look alikes" or conducting cost studies on a sample of current non-record keepers. NECA has previously estimated that it would take four years to complete cost studies on a large sample of current average schedule companies and that the expense of doing so would far exceed the considerable expense incurred in the present exercise.[32]

20. ICORE has suggested no reason that a "look alike" process, per se, should yield unreasonable results. In the absence of any suggestions to the contrary, it seems reasonable to expect that, if average schedule companies allocated their costs following the same rules and procedures that similar cost companies do, the allocation results would be similar. A "look alike" process should produce reasonable results if the cost companies sampled are really similar to the average schedule companies they are intended to look like.

21. NECA has provided a variety of statistics (such as lines, number of exchanges, and minutes) for both the entire population of average schedule companies and for each of the "look alike" cost companies. Summary statistics are presented in Exhibits 4.3 and 4.4 of NECA's filing and more detailed information is supplied in Appendixes D and E. Based on these comparative statistics, the weighted sample of cost companies appears to be very similar to the population of average schedule companies. We have applied a standard statistical test to determine whether the "look alike" cost companies are similar to the average schedule companies they are intended to represent. The specific test compared the variance and mean of the sample of cost companies with the mean of the population of average schedule companies. We applied that test to both the total number of company access lines and the number of access lines per exchange. These two variables (access lines and access lines per exchange) determine the amount of compensation that each average schedule company will receive under the new common line basic formula. We found that in neither case did the

cost companies differ significantly (in terms of "statistical significance") from the universe of average schedule companies. We therefore conclude that the "look-alike" cost companies selected by NECA are not significantly different from average schedule companies.[33] Furthermore, the "look alike" companies were used for only one purpose --to develop allocation factor models with which to estimate the average company data shown in Appendix G. The resulting allocations, reflected in the data in Appendix G, have not been challenged by any of the 121 average schedule companies for which the allocations have been estimated.

22. In summarizing the development of estimated average schedule allocations, NECA concludes that "While there are undoubtedly many ways to comply with the requirements of Section 69.606(a), NECA's application of cost company allocation factors to average schedule financial data appears to be the most efficient way of utilizing available data and resources."[34] We agree that NECA followed a reasonable procedure that is consistent with applicable rules.

23. Having estimated interstate cost allocations for a sample of average schedule companies by access cost category, NECA then attempted to find formulas that most accurately would compensate the average schedule companies for their interstate access costs. The general approach used regression analysis to find the closest relationships between demand variables and the costs to be recovered. Having developed basic formulas to reimburse average schedule companies for their interstate costs, NECA then undertook to adjust those formulas for a variety of changes that have occured in the industry (see paras. 27 and 28, below). The ultimate result was the development of seven formulas, each of which is proposed to compensate average schedule companies for a portion of their costs.[35] For example, average schedule companies would be reimbursed for their "Traffic Sensitive Central Office" costs using a formula that pays them 3.0216 cents per minute plus a per minute fee that varies with the company's activity per exchange (with smaller, less busy exchanges receiving higher compensation per minute than larger exchanges). The sum total of payments under these seven formulas would be the compensation received by average schedule companies for their provision of interstate access.

24. We find NECA's use of regression analysis to be a reasonable application of standard econometric techniques. Five of the seven settlement formulas have not been challenged by any party. However, two settlement formulas -- those dealing with common line costs and line haul costs have been challenged and are discussed in a later section.

25. The NECA methodology produced results that are consistent with the expected impact of the changes that the Bureau directed NECA to make in revising average schedules. Because of a series of changes occurring in the telephone industry over a period of years, telephone companies now assign fewer of their costs to the interstate jurisdiction for cost recovery. Both inside wiring and terminal equipment were traditionally provided by local telephone companies. A portion of these costs was assigned to the interstate jurisdiction and recovered through tariffed rates. The regulatory status of these activities has changed. The Commission has determined that these activities should not be classified as Title II services. The embedded costs of activities previously undertaken by telephone companies either have been (as in the case of CPE), or are being (as in the case of inside wire), phased out of the rate base. Lower tax rates and changes in the separations process have also reduced the costs that carriers allocate to the interstate jurisdiction for cost recovery. The inevitable result of these changes is that *any* set of revised average schedules will, on average, lower the payments received by average schedule companies. According to NECA's estimates, the new schedules will lower payments to average schedule companies, by an amount averaging about 10.5%. No party has challenged this estimate nor suggested that the overall reduction is inaccurate.

26. Both Consolidated and ICORE have urged that the Commission reject the new settlement formulas because, in their view, the new schedule of payments would have adverse effects on the smallest average schedule companies. In ICORE's view, the " . . . revised schedule structures impose a disproportionate share of settlements reductions on the very smallest companies."[36] Similarly, Consolidated argues that " . . . NECA's filing is flawed because of the disproportionately large impact that the revisions would have on the smallest average schedule companies."[37] ICORE maintains that the impact statement prepared by NECA shows that the decreases experienced by the larger companies are "significant decreases to be sure -but nowhere near the level of dislocation experienced by the very smallest companies." "In fact," ICORE continues, "every one of the 71 companies losing more than $3.00 per access line is under 5000 lines, with 24 having fewer than 500, and 10 below 100."[38]

27. ICORE's argument is not persuasive. One would expect that an accurate average schedule revision would have a greater dollar per line impact upon smaller companies. Average schedules have traditionally provided higher compensation (measured on a per line basis) to smaller companies. The newly proposed schedules maintain this pattern. However, the fact that smaller companies have traditionally received higher payments per line than larger companies means that a percentage change, applied equally to all companies, would result in a greater reduction in dollars per line for smaller companies. Thus a company that had traditionally received $30.00 per line per month, and which experienced a 10% reduction, would experience a reduction of $3.00 per month per line. Conversely, a company previously receiving only $10.00 and experiencing the same 10% reduction, would have its payments reduced only $1.00 per month. To the extent that conformance changes have reduced the costs allocated to the interstate jurisdiction for cost recovery, we might naturally expect that the reductions per month, expressed in dollar terms, will be greater for the smaller companies even if the percentage impact is the same as for larger companies.

28. Moreover, ICORE's description of the impact of the revisions is misleading. First, the impacts described by ICORE are the impacts *prior* to payments that would be made under a transition plan designed to mitigate the impact of the change. Second, even without the transition, a careful analysis of the data in NECA's Appendix H reveals that smaller companies, as a group, are not disadvantaged by the revised schedules. Even before transition payments are considered, the 48 companies faring best under the new plan each have less than 1000 lines. In fact, of the six companies that actually experience increased revenues under the new schedules, all have

fewer than 100 access lines and the largest gainer among all average schedule companies is the very smallest company of all --having only 18 access lines. After transition plan payments, NECA concludes that "only two average schedule companies will experience total reductions in excess of ten (10) percent during the expected life of the proposed schedules".[39]

29. In Exhibits 1 and 2 of its reply comments, NECA has summarized the data in Appendix H to support its view that settlement reductions are not disproportionate for study areas with few access lines. We have conducted a statistical analysis of the relationship between settlement impact (in percentage terms) and the size of company (in terms of access lines) among the average schedule companies. We have done so by using the data in Exhibits 1 and 2 to conduct chi-square contingency table tests of independence between impact and size. To do so, some of the cells in the tables were combined so as to make the expected frequency in each cell at least equal to 5 (a generally accepted minimum for applying a chi-square test). In both cases we found a significant relationship between company size and impact--but in the opposite direction than that argued by ICORE. In both cases, the reason that the relationship was statistically significant was the disproportionate number of small companies with low impacts. But while many smaller companies do worse than average, a disproportionate number do even better than the average. Thus, we can conclude from this that there is no disproportionate adverse effect for the category of small average schedule companies.

30. In reviewing NECA's overall methodology, we conclude that their methodology was sound, their research effort was carefully documented, and that their results are consistent with reasonable expectations. Further, we find no evidence that the ultimate results of their new schedules would be unduly detrimental to the smallest average schedule companies.

V. ISSUE ANALYSIS

A. *Conformance of schedules to reflect regulatory changes.*

1. *Description of changes.*

31. As noted above, the 1987 Order required NECA to revise the average schedules to reflect five regulatory changes. These changes included revisions to systems of accounts in Part 32 of our rules, the revised Part 36 separations manual, the revised cost allocation requirements established in CC Docket No. 86-111, revised Part 69 access charges, and changes in tax expenses pursuant to the Tax Reform Act of 1986.[40] NECA states that its proposed revisions accurately reflect these changes.[41]

32. In conforming the average schedules to reflect changes in Part 32 of our rules, NECA states that the most significant impact was due to the new capital to expense requirement that resulted in a 0.7% increase in interstate access revenue requirements. Accordingly, NECA revised each of the "baseline" average schedule formula amounts by 0.7% to account for this revenue shift.[42] NECA states that its Part 36 separations changes include "reformed" separations procedures for central office equipment (COE) investment, including Category 3 - Switching, and Category 4.23 - All Other Interexchange Circuit Equipment. Using data collected by the Federal-State Joint Board in Docket 80-286, NECA states that it computed a 12.55% change in switching revenue requirements and a -0.61% change in all other interexchange circuit equipment revenue requirements.[43]

33. NECA states that the primary Part 69 conformance change was designed to reflect new USOA and Part 36 Separations rules. NECA says that the most significant impact was caused by the new allocation procedure for general support facilities, which NECA claims has the effect of shifting revenue requirements from common line to traffic-sensitive access elements. Using data collected by the Commission from small independent telephone companies in Docket 87-113, NECA computed a 1.09% decrease in common line, an 8.76% increase in traffic-sensitive switching, and a 2.89% decrease in transport revenue requirements due to conformance changes.[44] To ensure that the average schedules conform to the new joint cost rules in Docket 86-111, NECA directed companies to exclude from their account balances costs associated with non-regulated activities. NECA states that by excluding such costs from average schedule account balances, the average schedule company Part 69 results used in "baseline" formula development also exclude such costs.[45] NECA states that the major effects of the Tax Reform Act of 1986 are the replacement of the 46% federal income tax rate with a 34% rate, and elimination of investment tax credits beyond 1987. NECA states that it computed the average schedule results for non-tax-exempt companies using a 34% federal income tax rate to determine the federal income tax component of revenue requirement, and projected cost growth ratios for average schedule companies without growing investment tax credits beyond 1987.[46]

2. *Positions of the Parties*

34. There is unanimous support for NECA's conformance of the schedules to reflect regulatory changes. For instance, ALLTEL states that NECA has "properly reflected" regulatory changes in the revised average schedules.[47] NTCA states that it agrees with NECA's methodology and results in adjusting the schedules to reflect the regulatory changes cited by this Commission.[48] Shenandoah states that the regulatory changes have resulted in proposed reductions to its settlements, but that NECA has employed "reasonable" procedures in modifying the schedules.[49] USTA concludes that the revised schedules "properly reflect" industry changes already incorporated by cost companies.[50]

3. *Discussion*

35. At the outset, we note the absence of a single methodological challenge to NECA's efforts to reflect these changes. To reflect each of these five recent changes, NECA describes its specific methodology for changing the schedules, and quantifies the effects on the schedules. Based on the record and the review we have conducted of NECA's methodology and results, we conclude that NECA has accurately performed the difficult task of conforming the schedules to reflect complex regulatory changes. In light of these considerations, we find that NECA has adequately conformed the average schedules to reflect changes in Parts 32, 36, and 69 of the Commission's rules, as well as effects of the Joint Cost Rules and the Tax Reform Act of 1986.[51]

B. *CABS*

1. *Description of proposed CABS revisions.*

36. As noted above, the 1987 Order found that it is appropriate for NECA to provide for the recovery of CABS and Administrative Expenses through the average schedules. However, we directed NECA to "take cognizance of, and test, additional functional forms that explore the relationship between the base, or fixed, component of CABS and Administrative Expenses and total CABS and Administrative Expenses". We also stated that we expected NECA to include in its proposed revisions modifications that more closely simulated the disbursements that would be received by cost companies.[52]

37. NECA proposes to replace the existing method by which CABS and Administrative Expenses are recovered on an actual costs basis with a formula under which average cost companies would recover a fixed settlement per month of $385.90 for CABS and Administrative Expenses along with an amount per minute for each switched access minute.[53] NECA derived the formula by testing several variables and determining that access minutes was the best indicator of CABS and Administrative Expenses.[54] It then tested for the proper cost per minute of access minutes to recover CABS and Administrative Expenses and found that the data suggested the propriety of a minimum fixed settlement in addition to the average amount per minute.[55]

2. *Positions of the Parties*

38. NTCA notes that the NECA developed a separate CABS formula in order to limit complexity, eliminate over-recovery, and maintain integrity by removing the possibility of manipulation. NTCA contends that NECA's proposed CABS formula is responsive to the needs of the smallest LECs by providing a settlement floor.[56] Union Springs agrees that the CABS settlement floor is very helpful for the small average schedule companies.[57] USTA states that NECA's proposed CABS formula will avoid the need for average schedule companies to "track" the actual costs of providing access billing and administrative services and is consistent with the 1987 Order.[58]

3. *Discussion*

39. NECA has designed a CABS and Administrative Expenses formula that complies with the directives in our 1987 Order. NECA tested a number of variables to determine a formula that best simulated the disbursements that are received by cost companies for related expenses. Likewise, it tested, and settled on a fixed settlement floor as part of the formula that would most accurately reimburse average schedule companies for their CABS and Administrative Expenses. The commenters that address the issue all support the methodology that NECA employed in determining its proposed CABS and Administrative Expenses formula, and specifically commend that settlement floor as a device to ensure equitable cost recovery for small average schedule companies. In light of these considerations, we approve this aspect of NECA's proposal.

C. *Common Line Formula*

1. *Description of the Common Line Formula*

40. NECA's new common line formula was developed in the same manner as the other settlement formulas. Based on their sample of "look alike" cost companies NECA developed a series of allocation factor models to describe the way that such companies allocate their maintenance, depreciation, and other expenses to the common line category. These allocation factors were then applied to the expenses of the average schedule companies in NECA's sample. The result was an approximation of the costs that average schedule companies would allocate to the common line category if average schedule companies allocated their costs in the same manner as cost companies. Using this distribution of costs, NECA attempted to find a formula that would best compensate average companies. As with the other six settlement formulas, this was done with the use of regression analysis--attempting to find a line (or formula) that provided a "best fit" with the data.

41. The resulting settlement formula would pay most exchange carriers $6.99 per access line per month. In contrast, the current settlement formula pays most carriers $8.08 per access line per month. Smaller average schedule companies would receive $12.98 per line per month minus an amount depending on the number of access lines per exchange. The current formula provides $16.16 per line per month minus an amount depending on the number of access lines per exchange. The new formulas are thus similar to NECA's current common line formulas with two exceptions. First, the demarcation point between larger and smaller average schedule companies is shifted (from 417 lines per exchange under the existing formula to 385 lines per exchange under the proposed formula). Second, the amount of compensation provided to all companies is lower for the reasons discussed in paragraphs 34-38.

2. *Positions of the Parties*

42. ICORE argues that, "While each cost company applies its unique phasing SPF to its specific NTS loop costs, NECA ignores this basic separations principle in its CL formula. All but a handful of average schedule companies (those with fewer than 385.55 lines per exchange) are assumed to have exactly the same SPF and exactly the same loop cost, giving them each exactly the same settlement of $6.99 per access line."[59] ICORE says that it "has long asked for CL schedules which, using a surrogate SPF and a surrogate NTS loop cost mechanism, would recognize the very real differences among average schedule companies either individually or in stratified groups or bands."[60]

3. *Discussion*

43. NECA did not assume that most average schedule companies have exactly the same loop costs. Thus, ICORE seems to misunderstand the process NECA used in developing its settlement formulas. The settlement formulas were based on regression equations using the estimated costs of a sample of average schedule companies. Those estimated costs, in turn, were developed by taking the expenses of the average schedule companies and attempting to allocate those expenses among access cost

categories in a manner representative of the way in which cost companies allocate their expenses among access cost categories.

44. Second, the settlement formulas are intended to reimburse average schedule companies for the "average costs" they incur. Adopting ICORE's suggestion to construct a unique "SPF" for each average schedule company would be inconsistent with the concept of an average schedule. In the development of its common line formula, NECA reasonably chose to base the settlement formula on that variable most closely correlated with common line costs -- the number of lines. Rather than using a single formula which would treat all companies identically, however, NECA developed two separate formulas, the effect of which is to provide higher settlement payments to the smallest companies. NECA realized that the accuracy of its approach could be slightly improved (about 2%) by including a "minutes per line" variable but decided not to do so. NECA's reason for doing so was that "this change would cause significant settlement shifts for individual average schedule companies immediately, and subsequent significant shifts in the reverse direction over the next three years."[61] We agree that such fluctuations in settlement payments add unnecessary instability to the average schedule process and are not worth the small increase in accuracy that would result from inclusion of this additional variable.

45. The settlement formula applicable to the smallest average schedule companies (those with fewer than 385.55 lines per exchange) is dismissed by ICORE as applicable to only a "handful" of companies. Actually, somewhere between 90 and 100 average schedule companies have fewer than 385 total lines and therefore are covered by the higher rate automatically (the number varies slightly depending whether the 1987 lines in appendix H are considered or whether the estimated 1989 lines in appendix D are considered). In addition, a number of larger companies also qualify for the higher rate (because they have more than one exchange but fewer than 385 lines per exchange). The number of such companies, based on the weights and sample data in appendix D3, appears about equal to the number of smaller companies. Thus, it appears that nearly 200 companies -- rather than a mere handful -- will be covered by the higher common line rates applicable to the smallest companies. Both the procedures used by NECA in developing common line formulas and the resulting common line formulas appear reasonable.

D. *The New Distance Sensitive Line Haul Formula*

1. *Description of the Formula*

46. ICORE and Consolidated also challenge the settlement formula for "distance sensitive line haul" facilities. NECA constructed its proposed settlement formula for distance sensitive line haul costs in the same manner as its other settlement formulas. Using the estimated costs of a sample of average schedule companies, NECA used regression analysis to determine which demand variables were most closely associated with these costs. NECA found that traffic sensitive access minutes were most closely correlated with the relevant costs.[62] The correlation coefficient was .8455. That is, about 85% of the variation in cost levels among the sample companies was associated with variations in the number of traffic sensitive access minutes. Under the new settlement formula ultimately selected by NECA, average schedule companies will receive compensation based on a combination of the number of interstate circuit miles in their system and on the number of interstate traffic sensitive access minutes attributable to the company. The new formula thus differs from the existing settlement formula which is based only on route milage and is not sensitive to traffic levels.

2. *Positions of the Parties*

47. Consolidated states that "This new formula penalizes a company such as Consolidated which, because of its unique and difficult service demands, carries a low number of minutes of use over a disproportionately high number of circuit miles."[63] Consolidated argues that "A far more practical and reasonable alternative to provide fair treatment of these unique situations is to employ a formula reflecting distance, either by route miles or sheath miles, as opposed to minutes of use."[64] ICORE is similarly critical, arguing that "no direct measure of distance, such as sheath miles, which is directly related to facility cost, was used in the formula."[65]

48. NECA defends its proposal in its reply comments and is supported by NTCA which represents 450 small and primarily rural cooperatives. In its reply comments, NTCA argues that changing technology has caused a shift in costs away from distance sensitivity to a mixture of both non-distance and distance sensitive characteristics.[66] NTCA also believes that the route mileage terminology currently in effect tends to be subject to differing interpretations and that "the application of this terminology to the widely diverse line haul configurations results in unanticipated, anomalous results." [67]

3. *Discussion*

49. Neither Consolidated nor ICORE dispute NECA's contention that traffic sensitive access minutes are much more highly correlated with distance sensitive transport costs than are the variables they suggest NECA should use instead. Indeed, NECA's reply comments emphasize,[68] as did their original filing,[69] that while the correlation between access minutes and transport costs is .8455, the correlation between costs and either circuit miles or route miles is substantially lower (.4242 and .2777, respectively). Thus, in seeking a relationship that would compensate most companies fairly, NECA clearly settled on the appropriate primary variable. Further, NECA went to considerable length to examine alternative formulations that might improve the settlement formula and ultimately selected a formula that reflects both traffic sensitive access minutes and "interstate circuit miles". Interstate circuit miles, in turn, are the sort of distance sensitive variable that Consolidated argues should be included.[70]

50. While NECA has utilized a distance sensitive variable of the general type advocated by Consolidated as part of its settlement formula, it has rejected the use of the specific variable (route miles) suggested by Consolidated. NECA's decision not to use route miles is soundly based on at least two reasons. First, as NECA observes in its filing, route mileage is not as highly correlated with costs as the alternative of circuit miles.[71] Second, as both NECA and NTCA observe, the use of route mileage in settlement formulas has led to ambiguities and difficulties in the definition and counting of route miles by average schedule companies.[72]

51. Consolidated also argues that "As one of the smallest average schedule companies, the impact on Consolidated as a result of the 1989 NECA revisions is not only severe, but grossly disproportionate to the impact on almost all other and far larger average schedule companies."[73] Elsewhere, Consolidated argues that "With over 220 sheath miles of toll cable, and only 2704 subscribers, Consolidated is unique among average schedule companies."[74] While Consolidated may well be unique, it is not one of the smallest average schedule companies. In fact, about two thirds of average companies have fewer lines. Hence, any disproportionate impact derives from Consolidated's unique characteristics rather than its small size. To the extent that Consolidated is indeed "unique among average schedule companies",[75] it cannot realistically expect an average schedule designed to fit the remaining companies to fit its unique needs. Indeed the use of regression analysis was intended to minimize the variation between costs and settlement payments for all companies. To select a different settlement formula designed to meet the needs of a uniquely situated carrier would inevitably disadvantage "non-unique" carriers.[76]

52. Although we have carefully examined Consolidated's objections to the Line Haul formula, we note that average schedules are inherently designed to compensate average or "typical" companies. Average schedules are not, by their very nature, well suited to address the needs of companies that, for one reason or another, have characteristics that are so unusual as to make them uniquely different from other companies. We conclude that NECA has indeed selected a settlement formula that will compensate most companies fairly.

E. *Proposed Transition Period*

1. *Description of Proposed Transition Period*

53. NECA has determined that the revised schedules will result in a average 10.5% annual settlement reduction, with 120 of the 771 average schedule companies facing an annual reduction in settlements (without transition relief) of greater than 20% of current revenues.[77] NECA proposes a transition plan that would phase-in the reductions over a maximum period of two years. Under this proposal, NECA states that transition payments would be calculated according to the relative severity of the impact on each average schedule company. Specifically, NECA proposes to determine transition payments by comparing individual company total settlements for the first nine months of 1988 to projected individual company settlements under the proposed revisions. Companies will receive transition payments in the greater of (i) one-twelfth of the average settlement reduction per line experienced by average schedule companies as a whole ($0.125 per month) or (ii) one twenty-fourth of the individual company's per line settlement reduction. In effect, the majority of average schedule companies that qualify for transition payments would have their monthly settlement reductions limited to $0.125 per line per month for a period less than or equal to two years. Some transition payment recipients would not complete their transition in 24 monthly reductions of $0.125. Under the NECA proposal, these companies will phase-down with twenty-four monthly settlement reductions at a rate of 1/24 their total reduction.[78]

2. *Positions of the Parties*

54. ALLTEL supports the proposed transition plan.[79] Consolidated, however, states that it stands to lose $28,662.40 per month, or $0.44 per line per month, under NECA's proposed transition plan,[80] and contends that NECA's transition plan provides "insufficient" relief. It proposes an alternative transition plan under which its settlement reductions would be capped at $0.125 per access line per month.[81] Consolidated states that the total cost of this plan in excess of NECA's plan, if applied only to itself, is $870,000.[82] As support for its proposed transition plan, Consolidated notes that the transition plan for changes to the average schedules in 1985 (ARPM transition) capped settlement reductions at $1.25 per access line per year, with a maximum reduction of $5.00 over four years.[83] Consolidated also contends that the three-year transition plan suggested by several parties will not address the underlying "inequity" of the proposed revisions.[84] In the alternative, Consolidated suggests a maximum annual reduction of $3.00 per access line.[85]

55. ICORE contends that the proposed transition is unfair and unacceptable for small companies. It notes that under the proposed transition plan, NECA would reduce the settlements to its largest loser "by a whopping $6.48 per line per year for two years", an amount that is five times the maximum annual reduction under the ARPM transition plan. ICORE proposes that settlement reductions under the proposed plan should be limited to $1.50 per line per year, until the next round of average schedule revisions become effective.[86]

56. Several companies address the propriety of a three-year, rather than a two-year, transition period. OPASTCO favors a three-year transition plan to help smaller average schedule companies become accustomed to the reduced settlements that will be forthcoming under the revised schedules.[87] After initially supporting the transition plan,[88] NTCA contends in its reply that it appears that in a small number of cases settlement reductions under NECA's proposed two-year transition plan could become "unmanageable" for some small LECs. It supports extending the transition plan to three years for certain companies to further reduce the maximum monthly reduction, by reducing monthly settlements by the greater of 1/12 the average reduction for all average schedule companies or 1/36 of the company's actual reduction.[89] USTA supports the proposed two-year transition plan,[90] although it would not oppose extending the plan to three years if all companies are treated alike under the plan.[91]

57. NECA replies that its proposed two-year transition period will "dramatically" lessen the impact of its proposed revisions to the average schedules. It contends that, including transition payments, only two average schedule companies will experience settlement reductions in excess of ten percent over current settlements during the expected fifteen-month life of the proposed schedules, and notes that one of these companies has decided to convert to cost settlements.[92] NECA addresses the alternative transition plans proposed by the commenters, concluding that the three-year transition plan proposed by OPASTCO would be the next best alternative to its own plan as it would only cost an additional $1.3 million. It states that Consolidated's proposal to limit monthly reductions at $0.125 per line would extend Consolidated's transition period to eight years. NECA also contends that Consolidated's proposal to cap monthly settlement reductions at $0.125 per line, if applied to all companies, would cost an additional $2.3 million in excess of NECA's plan. NECA

believes that ICORE's proposed transition plan is the least desirable of the proposed alternative transition plans.[93] NECA says ICORE's proposal is undesirable because companies would be protected to some extent against all adverse economic changes. NECA also contends that the ICORE plan would "perpetuate extremely excessive settlements to a small number of companies".[94] Depending on how ICORE interprets its plan, NECA says that the transition period for one company alone could either last 140 years at a total cost of over $500 million, or 770 years at a total cost of $15 billion.[95]

3. Discussion

58. As discussed above, significant industry changes since the last set of average schedule revisions became effective in June 1986 have resulted in reduced interstate revenue requirements. To reflect these changes, NECA has proposed a 10.5% average reduction in annual average schedule settlements in the absence of transition payments, with some companies facing a much greater annual reduction without such transition payments. In consultation with industry representatives,[96] NECA developed a two-year transition plan for companies that would be most severely affected by the settlement reductions. Although changes in average schedule settlements normally should parallel changes in cost company settlements, we find that the present circumstances do justify a transition plan for average schedule companies to allow those companies sufficient time to adjust to new conditions resulting from the decrease in interstate settlements.

59. NECA's proposed transition plan would provide substantial relief to companies facing settlements reductions. NECA has proposed a two-tier scheme to accommodate a transition for average schedule companies over two years. NECA includes an exhibit that demonstrates that under its transition plan all average schedule companies except Consolidated would experience average monthly settlement reductions of no greater than 10% over existing levels for the life of the schedules.[97] We believe that capping average monthly settlement reductions over the life of the proposed schedules at 10% is sufficient to prevent undue short-term hardship in adjusting to settlement reductions. Accordingly, we direct NECA to develop appropriate modifications to its transition plan to ensure that Consolidated does not experience an average monthly settlement reduction over the expected life of the proposed schedules in excess of 10% over current settlement levels.[98] This modified transition plan shall become effective as of April 1, 1989, and NECA should submit a copy of its modifications within 30 days of the release of this order for our examination. NECA may proceed with its modifications 30 days subsequent to its submission unless we determine that further changes are warranted.

60. We find that alternative transition plans suggested by some commentors are unjustified and unduly expensive. The decrease in average schedule settlements are due to industry and regulatory changes that reflect actual changes in interstate costs. Accordingly, we are not persuaded by Consolidated's suggestion that we develop a lengthy and expensive transition plan solely for its benefit that would no doubt be unfair to other companies.[99]

61. Some commenters suggest a three-year transition plan applied to all companies that would qualify for relief. However, supporters of this plan fail to produce any specific evidence that the settlement reductions under NECA's proposal would cause undue hardship. We are mindful of the difficulties faced by some small average schedule companies, but we are not persuaded that we should add another year to a transition program at a cost of $2.3 million, that will have to borne by interstate ratepayers.[100] The lack of justification applies even more strikingly to ICORE's proposed transition plan. No average schedule company requests, or demonstrates the need for, the level of transition aid proposed by ICORE, and NECA's analysis reveals that ICORE's proposed plan would be unduly expensive.[101]

VI. ORDERING CLAUSES

62. ACCORDINGLY IT IS ORDERED, pursuant to the authority that is contained in Sections 0.91 and 69.606(a) of the Commission's rules, 47 C.F.R. §§ 0.91 and 69.606(a), that the revisions to the average schedules that have been proposed by the National Exchange Carrier Association ARE APPROVED subject to the conditions described herein.

FEDERAL COMMUNICATIONS COMMISSION

Gerald Brock
Chief, Common Carrier Bureau

APPENDIX A

Parties Filing Comments

ALLTEL Corporation (ALLTEL)

Consolidated Telephone Company (Consolidated)

ICORE, Inc. (ICORE)

National Telephone Cooperative Association (NTCA)

Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)

Shenandoah Telephone Company (Shenandoah)

Union Springs Telephone Company, Inc. (Union Springs)

United States Telephone Association (USTA)

Parties Filing Informal Comments

Iowa Telephone Association (IOWA)

Minnesota Telephone Association (Minnesota)

Parties Filing Reply Comments

Consolidated

ICORE

NTCA

NECA

OPASTCO

Telephone & Data Systems, Inc. (Telephone & Data Systems)

USTA

FOOTNOTES

[1] NECA's Proposed Revisions to the Average Schedules for 1988, 3 FCC Rcd 172 (1988).

[2] The 1987 Order directed NECA to file its revisions not later than May 2, 1988. On April 12, 1988, however, we granted NECA's request that it file the proposed revisions not later than October 1, 1989. *See* NECA's Proposed Revisions to the Average Schedules for 1988, DA 88-455 (released April 12, 1988).

[3] A list of commenters appears in Appendix A. The abbreviations used in the Appendix for the various parties appear throughout this order.

[4] 47 C.F.R. § 69.606(a) (1987).

[5] *See* Report and Order in the Matter of Average Schedule Companies, 103 FCC 2d 1017 (1986); *approved on reconsideration*, 3 FCC Rcd 834 (1986); *remanded City of Brookings Municipal Telephone Company, et. al. v. FCC*, 822 F.2d 1153 (1987). The Court directed the Commission on remand to consider certain issues or alternatives that the Court found were not adequately addressed in the original order. However, the Court allowed the June 1986 revisions to remain in effect pending the Commission's decision on remand. In response to the Court's decision, the Commission has gathered extensive, additional information from NECA and pleadings from interested parties and is presently analyzing this record.

[6] *See* 47 CFR Parts 32, 36, and 69.

[7] 1987 Order, 3 FCC Rcd 173, at para. 8.

[8] *Id.* at 3 FCC Rcd 173, para. 9.

[9] *Id.*

[10] NECA Proposal at i.

[11] *Id.*

[12] *Id.*

[13] NECA Proposal at I-18.

[14] *Id.* at ii-iii.

[15] USTA Comments at 2-3.

[16] NTCA Comments at 1.

[17] *Id.* at 9.

[18] OPASTCO Comments at 1-2. As discussed below, OPASTCO requests a three-year transition plan for implementation of the proposed revisions.

[19] Shenandoah Comments at 1.

[20] Union Springs Comments at 2.

[21] Iowa Telephone Association Comments at 1; Minnesota Telephone Association Reply at 1; ALLTEL Comments at 1; Telephone & Data Systems Reply at 1.

[22] Consolidated Comments at 4, 6-7, 11.

[23] ICORE states that it represents "100 companies in the areas of settlements, separations and costs, and telephone engineeering". ICORE Comments at 1. However, it does not list the names of any companies that it represents, nor does it indicate which, if any, companies it is specifically representing in filing these comments.

[24] *Id.* at 1-2. ICORE's specific complaints are discussed separately below.

[25] *See infra*, at V E 3.

[26] Companies that find the use of average schedules disadvantageous because of unique situations or extraordinary expenses can generally choose to undertake cost studies and to settle on the basis of their actual costs. Such a company is in the same position as a taxpayer who uses the standard deduction but has the option of itemizing expenses if it is advantageous to do so. Having switched to a cost status, however, companies are not permitted to convert to the use of average schedules. The Commission requires cost companies to continue in that status rather than becoming average schedule companies, except for a one time conversion window established in 1987. *See* 2 FCC Rcd at 3960. As a result of this opportunity to convert, the number of companies using average schedules has increased. This implies that the existing average schedules provide, at least for many companies, more generous settlements than settlements based on individual cost studies.

[27] Technically, NECA analyzed "study areas" rather than companies. A study area generally consists of all of a particular company's operations in a particular state. Large companies that serve several states will thus have several separate study areas. Most smaller companies (both average schedule companies and similar cost companies) serve only one state. If a company serves only one state, there will be, in most cases, no difference between data for the company and data for the study area. In an attempt to keep the discussion as simple as possible, we will generally use the terms "average schedule companies" and "cost companies" rather than more technically precise references to "average schedule company study areas" and "cost company study areas".

[28] NECA Proposal at IV-114 - IV-126.

[29] ICORE Comments at 2.

[30] *Id.* at 3.

[31] *Id.*

[32] NECA, Average Schedule Information Request Response, September 15, 1987, Reply to Question 35, at 35-24 and 35-25.

[33] The sample weights can be scaled so that the sum of sample weights is equal to 1. When this is done, the sample mean (X) is equal the sum of $w_i X_i$ where w_i is the weight of the ith observation and X_i is the value of the ith observation. The standard deviation of the sample (s) is equal to the square root of: (n/n-1) multiplied by the sum of $(X_i-X)^2 w_i$ where n is the number of observations in the sample. The following "t-test" can be used to determine whether the sample mean differs significantly from the population mean (mew): t=(X-mew)/(s/square root of n). For the number of lines, the t statistic is .146. For the number of lines per exchange, the t statistic is -1.58. Both are clearly less than the critical value for commonly used significance levels.

[34] NECA Reply at 9.

[35] The development of the formulas is described in Section VIII of NECA's Proposal. *See id.* at I-26 and I-27.

[36] ICORE Comments at 6.

[37] Consolidated Reply at 2.

[38] ICORE Comments at 5. The NECA data that ICORE cites is contained in Appendix H of the NECA filing.

[39] NECA Reply at 22, footnote omitted.

[40] *See supra* note 6.

[41] NECA Proposal at IX-1.

[42] *Ex Parte* Letter, Richard A. Askoff, Attorney for NECA, to Ms. Donna R. Searcy, Secretary, Federal Communications Commission, filed February 22, 1989, Exhibit B at 1.

[43] *Id.*, Exhibit B at 2. NECA also states that its Part 36 changes to the average schedules include changes designed to conform separations procedures to the new USOA, but that these changes caused only minor jurisdictional revenue requirement shifts for the industry in total. *Id.*

[44] *Id.*, Exhibit B at 3.

[45] *Id.*, Exhibit B at 4.

[46] *Id.*, Exhibit B at 5. .

[47] ALLTEL Comments at 1-2.

[48] NTCA Comments at 10.

[49] Shenandoah Comments at 1-2.

[50] USTA Comments at 5.

[51] This is not to say that in future average schedule filings we might not conclude that certain further "conformance" revisions are necessary based on additional analysis and information, including the experience we gain regarding the impact of these changes on LEC interstate costs and the ability of NECA's methodology to reflect these changes accurately.

[52] *See supra* note 9.

[53] NECA Proposal at VIII-104. The specific formula would be Settlement Cost = $385.90 + $.000486 x TS minutes. *Id.* at VIII-121.

[54] *Id.* at VIII-105, VIII-112.

[55] *Id.* at VIII-112-113.

[56] NTCA Comments at 11.

[57] Union Springs Comments at 4.

[58] USTA Comments at 4.

[59] ICORE Comments at 3-4.

[60] *Id.* at 4.

[61] NECA Proposal at VIII-23.

[62] *Id.* at VIII-77.

[63] Consolidated Comments at 4, n. 5.

[64] *Id.* at 13.

[65] ICORE Comments at 6.

[66] NTCA Reply at 6.

[67] *Id.* at 7.

[68] NECA Reply at 12-13.

[69] NECA Proposal at VIII-77.

[70] *Id.* at VIII-85.

[71] *Id.* at VIII-77.

[72] NECA Reply at 14; NTCA Comments at 11.

[73] Consolidated Reply at 4, footnote omitted.

[74] *Id.* at 6.

[75] *Id.*

[76] Although we find that NECA's proposed distance sensitive line haul fomula is justified, we grant Consolidated supplemental transitional assistance to adjust to the new formula. *See infra* at V E 3.

[77] NECA Proposal at I-19.

[78] *Id.* at I-22 - I-24.

[79] ALLTEL Comments at 2.

[80] *Ex Parte* letter, Charles H. Helein, Counsel for Consolidated, to Ms. Donna Searcy, Secretary, Federal Communications Commission, filed February 23, 1989.

[81] Consolidated Comments at 6.

[82] Consolidated *Ex Parte* Letter, *supra* n. 79 at 2.

[83] Consolidated Comments at 4-10. Consolidated also notes that this Commission established an eight-year transition plan in 1984 for the move to a flat 25% SPF factor. *Id.* at 10.

[84] Consolidated Reply at 21-22.

[85] *Id.* at 10.

[86] ICORE Comments at 7-8; ICORE Reply at 5-6.

[87] OPASTCO Comments at 4-5.

[88] NTCA Comments at 13.

[89] NTCA Reply at 3.

[90] USTA Comments at 5.

[91] USTA Reply at 4.

[92] NECA Reply at 21-22.

[93] *Id.* at 24.

[94] NECA Reply at 25.

[95] *Id.* at 25-26.

[96] *See* NECA Proposal at ii.

[97] NECA Reply at 21, Exhibit 2. Actually, NECA shows that two companies would experience a reduction greater than 10%, but one of those companies is converting to cost status. *Id.* at note 27. NECA assumes a fifteen-month life for the proposed revisons, based on a April 1, 1989, effective date, and a July 1, 1990 effective date for new revisions. Although companies will complete their transitions over a period of up to two years, the fifteen-month life expectancy of the proposed revisions is a useful figure by which to assess the proposed transition plan because settlements may change after the next average schedule revisions become effective in July, 1990. Hence, beyond fifteen months it is impossible to predict settlement levels for specific average schedule companies. The 10% average reduction in settlements reflects the fact that settlement reductions are phased-in over the fifteen-month expected life of the schedules. Accordingly, settlement reductions in the first months of the transition will represent a cumulative reduction of less than 10%, while settlement reductions in the final months of the schedules will represent a cumulative reduction greater than 10%, with the *average* settlement reduction over the fifteen months at 10%.

[98] NECA should calculate the amount of money necessary to achieve this result (beyond that already provided in its proposed transition), divide that amount by fifteen, and provide Consolidated with fifteen equal supplemental transitional payments over the fifteen months, April 1989 through June 1990.

[99] Moreover, in directing NECA to modify its transition plan, we ensure that Consolidated's percentage reduction in settlements is comparable to that of other average schedule companies for the expected life of the schedules.

[100] Transition assistance costs are borne by carriers in the Common Line pool, and by carriers responsible for long term support for pool participants. These payments are, of course, recovered by these carriers in their interstate rates.

[101] Nor do we find persuasive, as certain parties suggest, that the 1986 ARPM transition plan capped average schedule settlement reductions at $1.25 per line per year, or that other transition plans for other purposes implemented by the Commission were phased-in over more than two years. These parties fail to note that at other times the Commission implemented certain regulatory changes, without a transition. Any transition must be tailored to specific circumstances. The 1986 ARPM transition plan reflected the fact that certain companies faced greater settlement reductions under that plan than under the proposed revisions at issue. (*See e.g.* ICORE Comments, In the Matter of Average Schedule Revisions, filed December 6, 1985, at 5, stating that certain companies faced a settlement reduction of 60% or greater under the proposed 1986 revisions.) Moreover, unlike the 1986 revisions, the proposed revisions at issue largely reflect

real cost decreases to carriers, such as the tax-rate decrease, that offset any hardship that carriers may face in responding to reductions in average schedule settlements.

Before the
Federal Communications Commission
Washington, D.C. 20554

In re Applications of

TED TUCKER AND JANA TUCKER
San Manuel, Arizona

File Nos. BMPFT-880329TA
BLFT-880512TD

For Modification of Construction Permit and License for FM Broadcast Translator Station K285DL

MEMORANDUM OPINION AND ORDER

Adopted: March 16, 1989; Released: April 17, 1989

By the Commission: Commissioner Quello dissenting in part, and issuing a statement.

1. The Commission has before it for consideration: (a) the above-captioned applications for modification of construction permit[1] (FCC Form 346) and for license for an FM broadcast translator station (FCC Form 347) filed by Ted Tucker and Jana Tucker (Tuckers);[2] (b) a petition for reconsideration filed May 25, 1988, by the Tucson Broadcasters Association (TBA); [3] (c) an opposition filed June 8, 1988, by the Tuckers; (d) a reply filed June 20, 1988, by TBA; (e) a pleading entitled "Petition for Reconsideration/Petition to Deny" filed July 25, 1988, by Joel Wayne Russell and Frances R. Russell (Russells); and (f) a motion to strike filed August 2, 1988, by the Tuckers.

2. The initial application for FM translator station K285DL was filed November 3, 1986, by Coronado Broadcasting Corporation, licensee of station KAWV(FM) (formerly KHYT(FM)), Oracle, Arizona. The applicant proposed to serve San Manuel, Arizona, with the translator rebroadcasting the signal of station KAWV(FM).[4] San Manuel is located within the 1 mV/m contour of station KAWV(FM), the primary station. However, due to intervening terrain features, reception of its signal there is inadequate. The unopposed application was granted on January 30, 1987. On March 29, 1988, the applicant filed an application to change from a directional to a non-directional antenna and reduce effective radiated power. The cover letter to the application advised that it was a minor change application and was therefore not subject to the freeze on acceptance of new or major change applications for commercial FM translator stations. It also noted that as a minor change application no fee was required. The application was not contested, and on April 25, 1988, was granted. The petitions for reconsideration of the April 25, 1988 grant followed.

The TBA Petition

3. 47 C.F.R. Section 1.106(b)(1) provides that a party seeking reconsideration who did not participate in the earlier stages of the proceeding must demonstrate how they are adversely affected by the action under reconsideration and show good reason why they were unable to participate in the earlier stages of the proceeding. TBA comprises several full service FM radio stations serving Tuscon, Arizona. Because the Tucker's translator, as modified, would directly compete with TBA member stations, TBA asserts that it will be adversely affected by the operation of that translator station. TBA further asserts that inasmuch as the Tucker's application to modify K285DL was granted four days after the release of a Public Notice announcing acceptance of the application, TBA did not have an opportunity to participate in the earlier stages of this proceeding. We believe that TBA has made the showing required per Section 1.106(b)(1) and therefore conclude that TBA has standing to file the instant petition for reconsideration.

4. TBA alleges that the March 29 amendment proposed substantial changes to the facilities authorized by the initial construction permit. TBA claims that under the rules this constitutes a major change and not a minor change as alleged by the applicant. According to TBA, the translator, as modified, would serve approximately 20 times the population as that located within the 1 mV/m contour of the primary station. This means that the translator station would serve 284,258 persons while the primary station's service area population is only 14,963. In addition, TBA asserts that the amendment increased the translator's 1 mV/m coverage area fourfold, from approximately 236 square miles to 992 square miles. Thus, the translator, which was granted authority to serve San Manuel, would now cover approximately 90% of Tucson. In TBA's view, the application to change the antenna system was clearly a major change application under the rules. As such, they contend it was unacceptable for filing because it was filed after the freeze was imposed on the acceptance of FM translator applications for new or major changes in facilities.[5] In addition, TBA alleges that the modified proposal is "technically flawed" in several respects. More specifically TBA alleges the following deficiencies:

> i) The modified proposal is mutually exclusive with an application filed by the Russells for a proposed new co-channel translator station to serve Tucson, Arizona.
>
> ii) The modified proposal will cause interference to a proposed new co-channel FM broadcast station at Kearny, Arizona.
>
> iii) The modified application violates Section 74.1235 in that it proposes the use of separate 10 watt outputs to feed a 4 bay antenna of which the horizontal and vertical elements may not be fed separately because each element of the antenna is used for both polarization components.

5. The Tuckers, in opposition, deny the allegations and assert that whether an application is a major change or not does not depend on the total size of the translator's proposed coverage area, the percentage change in the coverage area, the size of the proposed coverage area relative to the primary station's coverage area or the additional communities and areas which will fall within the proposed coverage area. According to the Tuckers a major change results only when a change is proposed in a translator's output channel or the community or area the translator is licensed to serve. In the Tuckers' view, their application did not involve any of these factors. The

Tuckers concede that station K285DL, as modified, will cause interference to the Russells' proposed new translator station. However, they counter that the Russells' proposal would cause interference to station K285DL's facilities as they existed prior to the March 29 amendment. In the Tuckers' view, this makes the Russells' application unacceptable for filing. Concerning the allegations of interference to a full service FM station, the Tuckers assert that TBA has not demonstrated that its modified facilities will cause interference as defined in the rules. In the event any interference is caused by the translator, the Tuckers represent that they will take such corrective action to eliminate the interference as the rules require. The Tuckers concede that their modified antenna proposal does not strictly conform to the rules. They assert, however, that the type of antenna system proposed is "well known to both the Commission and every competent consulting engineer" and complies with the limitations of the rules. The Tuckers assert that the application conforms to all Commission Rules. TBA, in reply, continues to object to the proposal.

6. 47 C.F.R. Section 73.3573(a)(1) concerns, in relevant part, the processing of FM translator station applications. It provides that any application proposing a change in output frequency, or authorized principal community or area is a major change application. Here, the Tucker's March 29, 1988, application to modify the facilities of station K285DL ostensibly proposed only to modify the antenna system. It did not explicitly propose a change in output frequency, principal community or area. It stands unrefuted on the record, however, that the proposed antenna modification would increase the station's coverage area fourfold and would increase the population served 20 times. In addition, the translator station's 1 mV/m contour would now cover 90% of Tucson, a community that it did not serve initially. The facilities proposed in the March 29 application substantially surpass the facilities authorized initially. The application proposed is clearly a major change and not a minor change as asserted by the applicant.

7. Ordinarily, in these circumstances, we would require the applicant to pay the filing fee for a major change application and place it on the next cut-off-list. Here, however, the application was filed on March 29, 1988, five days after our implementation of a freeze on the acceptance of applications for new commercial FM translator stations or for major changes in the facilities of existing commercial FM translator facilities.[6] The application is, therefore subject to the freeze. This means that it is unacceptable for filing and will be returned.

8. We recognize that the imposition of the freeze on the acceptance of FM translator major change applications has created a need for greater clarity in the standards used to define major and minor changes. FM translators generally have limited service areas and are not required to place any particular signal strength contour over the community or area to be served. Indeed, not all translators are licensed to serve defined communities.[7] Furthermore, very modest changes to the transmitting facilities of a translator, such as the replacement of an antenna or a slight shift in antenna location, will incidentally result in some change in the area served by the translator.[8] A rigid insistence that there be absolutely no change in area would require that most if not all changes in the facilities of translators be treated as major changes. That result would be incongruent with our characterization of modifications in the primary FM broadcast service and would serve no useful purpose. Clearly the language of Section 73.3573(a)(1) needs to be applied in a manner which will separate the inconsequential and unavoidable changes in area from the more substantial changes which warrant thorough scrutiny by the public and the Commission.

9. Therefore, for the purpose of administering proposals to modify the facilities of FM translators we will generally consider a proposal to be a minor change if at least 90% of the area within the proposed 1 mV/m contour is encompassed by the previously authorized 1 mV/m contour. This assumes, of course, that there is no change in output frequency or principal community. We believe that this approach will benefit all parties by enabling us to expeditiously dispose of applications involving insignificant and unavoidable changes in area and which are unlikely to affect the interests of other parties. Greater changes in area are, we believe, the result of deliberate design choices and should be treated as major changes.

10. Although dismissal of the Tuckers' March 29 application moots TBA's allegations concerning the proposal's technical deficiencies, TBA's petition raises a broader policy question. This question focuses on the types of antenna systems that can be used by FM translator stations, given advances in technology to achieve the power limitations set forth in Section 74.1235 of the rules.[9] Recent proposals contemplate use of systems that make more efficient use of available equipment, which are consistent with the spirit and the purpose of the existing rules, but which are arguably beyond the scope of the rules. We will therefore take this opportunity to clarify the scope of Section 74.1235 with regard to the the types of antenna systems that can be utilized for FM translator proposals to achieve the power limitations set forth in that section of the rules.

11. We will deal with two specific systems that are currently being proposed by applicants. The first of these is exemplified by the Tuckers' modification application. The Tuckers proposed to feed their circularly polarized antenna with a single transmission line powered by two separate 10 watt amplifiers. The second situation also involves the use of a single transmission line. The single line here receives its power output from a single amplifier and carries it to a power divider. The power divider then directs power to each of several antennas, all serving a different community, with each antenna receiving no more power than it would receive if a single amplifier with a single transmission line were being used. The problem is that Section 74.1235 does not contemplate combining power into a single transmission line. Nor does it appear to contemplate the use of a final radio frequency amplifier capable of producing more than the power output authorized by the rules.

12. The rule in fact is quite specific. Depending on the geographic location of an FM translator station's service area, a maximum of one or ten watts transmitter power output (TPO) of the final radio frequency (RF) amplifier may be fed to a single transmitting antenna. The TPO may also be divided between two or more transmitting antennas or arrays of antennas as long as a single feed is used to each antenna. The rule also provides that more than one radio frequency amplifier may be authorized in individual cases if each amplifier provides service to a different community. If more than one amplifier is used to provide service to the same community or area, the radiated fields from the separate antennas cannot combine

in any direction to attain an effective radiated power (ERP) in excess of that which would be produced by a single antenna fed by an amplifier operating at the authorized output power. Two amplifiers may also be used to serve the same community if one is used to feed an antenna producing a horizontally polarized signal and one is used to feed an antenna producing a vertically polarized signal. Thus, the rule requires each antenna or antenna array to be fed by a single RF amplifier with a power output no greater than the maximum authorized using a single transmission line.

13. The Tuckers proposed to use a single circularly polarized antenna, which would produce signals in both vertical and horizontal planes and to feed this one antenna with a single transmission line. Reading the rule literally, TBA contends that the Tuckers could not use an antenna that has integrated horizontal and vertical elements since it would not be possible to feed each plane separately. TBA further contends that the 20 watts TPO to be used to feed the single antenna was in excess of the 10 watts allowed by the rules, and therefore was prohibited.

14. Under the circumstances described by TBA it has been our practice to permit a single feed with double the transmitting output power otherwise allowed. This is so because the effect is no different than if separate feeds were used to serve separate antennas, one producing a horizontally polarized signal and the other producing a vertically polarized signal. In the case of a dual plane polarized antenna, the antenna gain factor, or multiplier, for each plane is one half that of a single plane polarized antenna. Hence, if only a 10 watt TPO feed were used, the equivalent antenna output power and attendant coverage would be half that of an equal size single plane polarized antenna. Thus, a feed with twice the authorized TPO is allowed to feed a circularly polarized antenna comprised of integrated vertical and horizontal elements on the single antenna since the net result is equivalent antenna output power. This approach accommodates the use of more technically advanced equipment and is a more economical and efficient means of providing coverage to an authorized service area, but does not undermine the intent of the rule.

15. Section 74.1235 also provides that if multiple antennas or antenna arrays are used to serve separate communities, each must have a single amplifier of no more than 1 or 10 watts and each must use a separate transmission line to feed each transmitting antenna. Theoretically, this means that a proposal to serve two different communities using two different directional antennas would require two amplifiers and two separate feeds. However, we see no inconsistency with the rules to allow a single amplifier in excess of 1 or 10 watts and a single transmission line to feed multiple antennas. Numerous applicants have shown that this can be accomplished by locating a power divider on the tower. The power divider takes the incoming power and divides it proportionately to supply each antenna with no more than its authorized power (one or ten watts, as appropriate). Although the output power of the final frequency amplifier is in excess of that permitted by the rules, these proposals are technically more efficient and comply substantially with the rule since no more than the authorized power is utilized by any one antenna. Accordingly, we will process and grant applications containing these proposals as being in conformance with the rules and therefore not requiring a waiver.

16. We wish to stress that these interpretations of the rules reflect current practice and are not a predetermination of new standards that might be adopted in light of our comprehensive Notice of Inquiry (NOI) on the role of the FM translator service.[10] Until we evaluate the comments filed in that NOI and adopt new rules, if any, we will continue to process applications consistent with current practices. It is the responsibility of the applicants to demonstrate that their proposals conform with the power limitation of the rule. It must also be shown that any non-conforming technical proposal will not cause interference to any regularly used off-the-air signal of any authorized broadcast station and otherwise conforms to all the rules concerning FM translator stations.

The Russell Petition

17. The Russell's contend that the Tucker's modification of K285DL will interfere with the new translator station proposed by the Russell's in application File No. BPFT-880301TB which was filed almost one month prior to the filing of the Tucker's modification application. The Russell's thus request reconsideration of the grant of the construction permit to modify K285DL and denial of the application for license to cover the construction permit. We note that as a petition for reconsideration, the Russell pleading is untimely since it was filed almost two months after the deadline for filing petitions for reconsideration in this proceeding. The Russells have offered no explanation as to why this pleading is untimely or, for that matter, why they were unable to participate in the earlier stages of this proceeding pursuant to 47 C.F.R. Sections 1.106(b) and (f). Accordingly, the petition for reconsideration is procedurally defective and will be dismissed. Furthermore, 47 U.S.C. Section 319(c) excludes applications for license to cover construction permits from those applications against which a petition to deny may be filed. Accordingly, as a petition to deny, the Russell pleading is also procedurally defective and will be dismissed. Furthermore, the application for license to cover construction permit BMPFT-880329TA was amended on June 13, 1988, to specify construction permit BMPFT-861103TD as the authorization for which a license to cover is being sought. Because the Russell's have no objection to grant of a license to cover BPFT-861103TD, their pleading, when treated as an informal objection to grant of the license application, is moot.

18. Accordingly, for the reasons stated herein, the petition for reconsideration filed by the Tuscon Broadcasters Association IS GRANTED to the extent set forth above and in all other respects IS DISMISSED as moot; the petition for reconsideration/petition to deny filed by Joel Wayne Russell and Frances R. Russell IS DISMISSED; the grant of construction permit BMPFT-880329TA IS RESCINDED and application File No. BMPFT-880329TA IS RETURNED as unacceptable for filing pursuant to the freeze on acceptance for filing of applications for new or major changes to the facilities of commercial FM translator stations; and the license application (BLFT-880512TD), as amended, to cover construction permit BPFT-861103TD IS GRANTED.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

FOOTNOTES

[1] The modification application was filed by Coronado Broadcasting Corporation. Subsequently the Corporation was dissolved and the permit for station K285DL, pursuant to Commission consent, was assigned to the stockholders, Ted Tucker (50%) and Jana Tucker (50%) (BAPFT-880421TB granted May 6, 1988).

[2] The license application was originally filed to cover the construction permit as modified by BMPFT-880329TA. It was subsequently amended to cover the original construction permit BPFT-861103TD.

[3] The Tucson stations joining in the filing of this petition are KJYK(FM), KWFM(FM), KROQ(FM) and KLPX(FM).

[4] FM translator stations are low power secondary service broadcast stations. They retransmit the signals of an FM radio broadcast station or another FM broadcast translator station without significantly altering any characteristics of the incoming signal other than its frequency and amplitude. They are intended to provide FM broadcast service to areas and populations which are unable to receive satisfactory service by reason of distance or intervening terrain obstructions. *See Report and Order, Amendment of Part 74 of the Commission's Rules and Regulations to Permit the Operation of Low Power FM Broadcasting Translator and Booster Stations*, 20 Rad. Reg. 2d (P&F) 1538 (1970). FM translators are authorized without regard to the FM table of allotments. They are permitted to operate only where they cause no interference to the direct reception by the public of the off-the-air signal of any authorized broadcast station, including Class D noncommercial educational FM stations. *See generally* 47 CFR 74.1200, *et seq.* (1988).

[5] *See Public Notice, Freeze Imposed on Filing of Applications for New FM Translator Stations*, Mimeo 2249, released March 24, 1988.

[6] *See* n.5, *supra*.

[7] *See*, for example, station K224BM, Rural Utah County, Utah.

[8] The 1 mV/m contour is commonly used in the estimation of coverage and is used, when appropriate, for processing FM translator applications.

[9] Section 74.1235, in part, states:

> (a) The power output of the final radio frequency amplifier of an FM translator shall not exceed 10 watts, except that FM broadcast translator stations serving areas east of the Mississippi River or in Zone I-A shall be limited to 1 watt. This power may be fed into a single transmitting antenna or may be divided between two or more transmitting antennas or arrays of antennas in any manner found useful or desirable by the licensee. In individual cases, the Commission may authorize the use of more than one final radio frequency amplifier at a single station under the following conditions:
>
> (1) Each such amplifier shall be used to serve a different community or area. More than one final radio frequency amplifier shall not be authorized to provide service to all or part of the same community or area, except as provided in paragraph (a)(2) of this section.
>
> (2) The transmitting antennas or antennas arrays shall be so designed and installed that the radiated fields from the separate antennas shall not combine in any direction in any single plane of polarization to achieve the effect of radiated power in excess of that which would be produced by a single antenna or antenna array fed by a radio frequency amplifier with power output no greater than that authorized pursuant to paragraph (a) of this section. Two radio frequency amplifiers may be used to serve the same community if one is used to feed an antenna designed to produce a horizontally polarized signal, and the other a vertically polarized signal.

[10] *Notice of Inquiry, Amendment of Part 74 of the Commission's Rules Concerning FM Translator Stations*, 3 FCC Rcd. 3664 (1988).

SEPARATE STATEMENT OF COMMISSIONER JAMES H. QUELLO DISSENTING IN PART

In re: Applications of Ted Tucker and Jana Tucker, San Manuel, Arizona

I support the majority's decision that the application constitutes a major change. As the majority correctly note, the proposed modification would increase the station's coverage area fourfold and would increase the population served 20 times. The proposed facilities would substantially exceed those authorized. Because the aplication was filed after we imposed our freeze on acceptance of new commercial translators, it is an unacceptable major change subject to the freeze.

I must disagree, however, with the decision to consider a 10% change in a translator's service area as a minor change, *per se*. Instead, the Commission should examine each proposal to determine whether the change is insubstantial or unavoidable. Such an analysis would be particularly appropriate where a 10% increase in coverage is directed towards areas already served by full service facilities. Given the disposition of the application in this case, there is no need to address the broader policy issues concerning single or multiple transmission lines that serve multiple antennas. Technical questions relating to Section 74. 1235 of the rules are better left to our comprehensive examination of translator policies. *Notice of Inquiry* in MM Docket No. 88-140, Amendment of Part 74 of the Commission's Rules concerning FM Translator Stations, 3 FCC Rcd 3664 (1988). Acordingly, I dissent in part to the Commission's decision.

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

AMERICAN TELEPHONE AND TELEGRAPH COMPANY — File No. I-T-D-89-003

CUBAN AMERICAN TELEPHONE AND TELEGRAPH COMPANY

Application for authority to deactivate and retire the Key West-Havana #5 and #6 Cable System

ORDER AND CERTIFICATION

Adopted: April 12, 1989; Released: April 20, 1989

By the Chief, International Facilities Division:

1. On December 16, 1988, the American Telephone and Telegraph Company and the Cuban American Telephone and Telegraph Company (applicants) filed the above-captioned application, requesting authority pursuant to Section 214 of the Communications Act of 1934, as amended, to deactivate and retire the Key West-Havana #5 and #6 Cable System. The application was placed on public notice on December 28, 1988. No comments were received.

2. The Key West-Havana #5 and #6 Cable System was placed in service in 1950, and is now 39 years old. The Key West-Havana #5 and #6 cables failed on April 25, 1987, and since that time the 24 circuits on that facility have been transferred to the U.S.-Cuba Over-the-Horizon Troposcatter System. (OH System). The 39 years old Havana cable has been subject to frequent failures and outages, and because of its age and deteriorated condition, the decision was reached to retire this cable. No services will be discontinued, reduced or impaired as a result of this deactiviation, since such needs are currently being met by OH System. In the near future, the recently authorized U.S.-Cuba No.7 Cable, will also be available to furnish service to Cuba.

3. Upon review of the application, we find that the Key West-Havana #5 and #6 Cable System has reached the end of its useful service life and that substitute facilities between the U.S. and Cuba are available. Under these circumstances we conclude that the permanent discontinuance of the Key West-Havana #5 and #6 Cable System and the transfer of service to the OH System can be accomplished with no discontinuance, reduction, or impairment of any service to any community or any part of a community now served by the Key West-Havana #5 and #6 Cable System.

4. Accordingly, IT IS HEREBY CERTIFIED that neither the present nor future public convenience and necessity will be adversely affected by the discontinuance of use and operation by the applicants of the Key West-Havana #5 and #6 Cable System and the substitution of the OH facility.

5. Within 60 days after the release of this order, the applicants shall notify the Commission of the accounting treatment they intend to use in retiring the Key West-Havana #5 and #6 Cable System.

6. Upon discontinuance of use and operation of the Key West-Havana #5 and #6 Cable System, the applicants shall notify the Commission thereof and submit to the Commission for cancellation any submarine cable landing license they possess covering the Key West-Havana #5 and #6 Cable System.

7. This order is issued under Section 0.291 of the Commission's Rules and is effective upon adoption. Petitions for reconsideration under Section 1.106 or applications for review under Section 1.115 of the Commission's Rules may be filed within 30 days of public notice of this order (*see* Section 1.4(b)(2)).

FEDERAL COMMUNICATIONS COMMISSION

George S. Li
Chief, International
Facilities Division
Common Carrier Bureau

Before the
Federal Communications Commission
Washington, D.C. 20554

In re Application of

MESSAGE CENTER, INC. File No. 20216-CD-P/L-84

For a construction permit to establish a new one-way facility under Call Sign KNKC241 on 158.10 MHz at Burlington, Vermont

In re Application of

KARL A. RINKER d/b/a RINKERS COMMUNICATION File No. 25035-CD-P/L-85

For a construction permit to change frequency under Call Sign KPA389 from 43.46 MHz to 158.10 MHz at Lincoln, Vermont

MEMORANDUM OPINION AND ORDER

Adopted: April 12, 1989; Released: April 20, 1989

By the Acting Chief, Mobile Services Division:

1. The captioned application of Message Center, Inc. (Message) was selected first, and the application of Karl A. Rinker d/b/a Rinkers Communication (Rinker) was selected second, in the lottery conducted on October 30, 1987.[1] Rinker filed a Petition to Dismiss or Deny Message's application. Responsive pleadings were filed.

I. BACKGROUND

2. Message filed an application for a new one-way station for frequency 35.22 MHz on October 20, 1983. On May 14, 1984, Message filed a major amendment to change frequency from 35.22 MHz (which is both a wireline and a non-wireline frequency) to 152.84 MHz (which, at the time of filing, was a wireline frequency). The amended application was electrically mutually exclusive with the applications of Waitsfield Fayson Telephone Company (Waitsfield) at Waitsfield, VT, File No. 21138-CD-P/L-84; and Tele-Rad, Inc. (Tele-Rad) at Burlington, VT, File No. 22659-CD-P/L-84. The Waitsfield application was the first of the three applications to be placed on Public Notice and therefore establishes the beginning of the cut-off period. Waitsfield's application appeared on Public Notice February 1, 1984.[2]

3. On January 14, 1985, Message filed a second major amendment (*i.e.*, its captioned application) to change its frequency from 152.84 MHz to 158.10 MHz (a wireline frequency). Due to an error, the amendment was not placed on Public Notice until January 26, 1986. Message requested that the amendment not be considered newly filed pursuant to Section 22.23(g)(6)[3] of the Commission's Rules.[4] On September 10, 1985, Rinker filed its captioned application for 158.10 MHz at Lincoln, VT. The application appeared on Public Notice November 6, 1985.[5] Rinker's and Message's captioned applications are electrically mutually exclusive, and a lottery was held which resulted in Message's application being selected first.

II. CONTENTIONS OF THE PARTIES

4. Rinker asserts that Message's May 1984 amendment was cut off by the previously filed mutually exclusive applications of Waitsfield and Tele-Rad and should have been returned as defective. Therefore, Rinker claims that Message's January 1985 amendment should not have been accepted because pursuant to *Allen C. Moore*, 86 FCC 2d 787 (1981) (*Moore*), major amendments may not be filed to correct defective applications. Second, Rinker argues that Message's claim that its January 1985 amendment should be accorded treatment under 22.23(g)(6) of the Rules, must be denied. Rinker states that Message has given no reason for its conclusion that denial of frequency coordination is not reasonably foreseeable. Third, Rinker believes that the second amendment filed by Message on January 14, 1985, did not give a sufficient reason to waive the then-separate frequency allocations for wireline/non-wireline carriers.[6]

5. In its opposition, Message states that its January 1985 amendment should not be treated as newly filed for two reasons. First, since the filing of Tel-Rad's application did not appear on public notice until after Message's amendment had been tendered, Message could not have been aware that it was filing a cut-off application. Moreover, Message claims Section 22.23(g)(2)[7] applies because the amendment resolves a frequency conflict with Tel-Rad. Second, Message argues that the amendment sought to cure an interference problem with a Canadian licensee.[8] Message believes that the Canadian interference problem was unforeseeable and that the January 1985 amendment was prompted by the Commission's letter. Accordingly, Message argues the amendment should not be considered newly filed pursuant to Section 22.23(g)(6). *See* footnote 3, *supra*. Message contends that under *Moore*, a major amendment may cure a defective application as long as the amendment is not considered newly filed. Message claims that its waiver request of the then-separate frequency allocations for wireline-nonwireline carriers was valid and was in response to the Commission's interim waiver policy and that no further justification was necessary. *See Public Mobile Services*, *supra*.

III. DISCUSSION

6. Rinker's argument that Message's first amendment, filed May 1984, was cut off by mutually exclusive applications filed by Waitsfield and Tel-Rad is correct. Since Waitsfield's application was the first one listed on Public Notice (on February 1, 1984), it established the beginning of the cut-off period. *See* Sections 22.31(b) and (c) of the Rules. While Message's application and Waitsfield's application are not directly mutually exclusive with each other, they are both mutually exclusive with Tel-Rad's application. Because Message's amendment was filed on May 14, 1984, more than 60 days after the February 1, 1984 Public Notice date of Waitsfield's lead application, it was cut off. Had the Commission's staff made this deter-

mination at the time Message's amendment was filed, Message's application would have been dismissed as defective pursuant to Section 22.20(b)(7) of the Rules.[9] Nevertheless, the issue as to whether the first amendment to that application was defective has no bearing on the filing of the second amendment. Even if the first amendment had been dismissed in a timely fashion, Message could still have filed its second amendment as a new application. Whether the application was styled a second amendment or a new application is of little consequence since the second amendment was treated as a newly-filed amendment.

7. We have examined the question of whether Message's second amendment to change frequency from 152.84 MHz to 158.10 MHz was entitled to consideration under Section 22.23(g)(6) of the Rules. The Commission notified Message on September 24, 1985, that the amendment to 158.10 MHz created a new interference problem with a Canadian licensee. The fact that a new interference problem had been created by the filing of the second amendment is enough to remove the second amendment from consideration as not being newly filed. Since a new frequency conflict has been created, the amendment to change frequency from 152.84 MHz to 158.10 MHz is not entitled to treatment under Section 22.23(g)(2) or (g)(6) of the Rules and, therefore, the amended application is considered newly filed.[10]

8. Furthermore, we find that Message's captioned application justified waiver of the wireline/non-wireline fence. Message claimed that the propagation characteristics in the wooded and mountainous terrain near the Burlington, VT site was undesirable and that the only other frequencies available were in the wireline allocation. The Commission in adopting the interim policy of accepting waiver requests did so because it feared that the remaining available frequencies may have been used up before any rule to eliminate the fence could have been adopted. Therefore, based upon Message's statements in its waiver request coupled with the Commission's interim policy concerning the separate frequency allocation as discussed in *Public Mobile Services*, Message's waiver request was fully supported and is granted.

IV. CONCLUSION AND ORDERING PARAGRAPHS

9. After carefully reviewing the facts and circumstances surrounding the record before us and based upon our acceptance of Message's assertions and Message's having been selected first in the lottery for mutually exclusive applications, we will grant Message's application. Furthermore, we find that Message has been found to be legally and technically qualified to construct and operate the requested facilities. Contemporaneously, we deny Rinker's petition and dismiss his application.

10. Accordingly, IT IS ORDERED, pursuant to Section 0.291 of the Commission's Rules, that the application of Message Center, Inc., File No. 20216-CD-P/L-84, IS GRANTED.

11. IT IS FURTHER ORDERED that the petition to dismiss or deny filed by Karl A. Rinker IS DENIED.

12. IT IS FURTHER ORDERED that the application of Karl A. Rinker dba Rinkers Communication, File No. 25035-CD-P/L-85, IS DISMISSED.

FEDERAL COMMUNICATIONS COMMISSION

Gregory J. Vogt
Acting Chief, Mobile Services Division
Common Carrier Bureau

FOOTNOTES

[1] *See* Public Notice, Mimeo No. 470, at 2 (released Nov. 4, 1987).

[2] *See* Public Notice, Rpt. No. 209, Mimeo No. 2124, at 4 (released Feb. 1, 1984).

[3] Section 22.23(g)(6) provides that an application will not be considered newly filed if a major amendment to it does not create new or increased frequency conflicts, and is demonstrably necessitated by events which the applicant could not have reasonably foreseen at the time of filing.

[4] If an amendment is considered to be a newly-filed application, competing applications may be filed against it.

[5] This application was an amendment to change frequency from 152.66 MHz to 158.10 MHz and amended Rinker's earlier pending application, File No. 23063-CD-P/L-84.

[6] When Message filed its original application and two amendments, there were separate frequency allocations for wireline and non-wireline licensees (also known as "the fence"). Wireline and non-wireline applicants could request frequencies from outside their allocation by requesting a waiver of then-pertinent Section 22.501(b), (c), or (h) of the Rules. *See* Revision and Update of Part 22 of the Public Mobile Radio Service Rules, CC Docket No. 80-57, Report and Order, 95 FCC 2d 769, 823-26 (1983) (hereinafter, " *Public Mobile Radio Services*").

[7] Section 22.23(g)(2) provides that an application will not be considered newly filed if a major amendment to it does not create new or increased frequency conflicts, and resolves frequency conflicts with other pending applications.

[8] The Commission had notified Message of the interference problem in a letter dated December 21, 1984.

[9] It is irrelevant that Message may not have known that it was filing a cut-off application. Section 22.31 makes no exception for late-filed applications.

[10] The interference problem was later corrected through the filing of minor amendments.

Before the
Federal Communications Commission
Washington, D.C. 20554

PUBLIC NOTICE

Released: April 20, 1989

PETITION OF AERONAUTICAL RADIO, INC., FOR DECLARATORY RULING REGARDING DOUBLE BILLING OF ACCESS CHARGES

Pleading Cycle Established

On March 27, 1989, Aeronautical Radio, Inc. (ARINC) filed a petition requesting that the Commission issue a declaratory ruling that local exchange carriers may not assess double access charges on calls to foreign exchange (FX) numbers in airline reservation networks that are ultimately completed over interexchange carrier-provided 800 Service.

ARINC claims that such a double charge is improper under Section 69.2(gg) of the Commission's Rules. It maintains that, as a minimum, FX service subscribers utilizing remote call forwarding functionality should be entitled to a credit for the duplicate terminating carrier common line charges that carriers have assessed on that service configuration.

Parties wishing to comment on the ARINC petition should do so no later than **May 30, 1989.** Reply comments should be filed no later than **June 15, 1989.**

Parties are requested to furnish copies of the comments to International Transcription Service, Inc., at their office in Room 246, 1919 M Street, N.W., Washington, D.C. 20554.

Copies of the petition may be obtained from International Transcription Service, Inc., 2100 M Street, N.W., Washington, D.C. 20036, (202) 857-3800. The documents will also be available for public inspection and copying in Room 518, 1919 M Street, N.W., Washington, D.C. 20554.

For further information contact Wanda M. Harris, Tariff Division, at (202) 632-6917.

FEDERAL COMMUNICATIONS COMMISSION

Before the
Federal Communications Commission
Washington, D.C. 20554

CC Docket No. 86-10

In the Matter of

Provision of Access for 800 Service — RM-5101

REPORT AND ORDER

Adopted: March 30, 1989; Released: April 21, 1989

By the Commission:

TABLE OF CONTENTS

	Paragraph
I. Introduction	1-3
II. Background	4-10
III. Issues	
A. Is the Data Base Plan in the Public Interest	11-40
1. Positions of the Parties	13-37
a. Benefits of the data base plan	13-16
b. Costs of the data base plan	17-30
i. Expense and Investment	18-19
ii. Post-dial delay	20-30
c. Alternatives to the data base plan	31-37
2. Discussion	38-40
B. Obligations of ITCs	41-45
1. Positions of the Parties	42-44
2. Discussion	45
C. Vertical Features	46-58
1. Positions of the Parties	47-52
2. Discussion	53-58
D. Cost Issues	59-74
1. Positions of the Parties	60-69
a. Identifying 800 Access Costs	60-63
b. Accounting Treatment	64-65
c. Separations Treatment	66-68
d. Part 69 Rules	69
2. Discussion	70-74
E. Administrative Issues	75-97
1. Service Order Issues	76-83
a. Positions of the Parties	76-82
i. Customer Point of Contact	76-77
ii. SMS Access by IXCs	78-80
iii. Subscriber Access to SMS	81-82
b. Discussion	83
2. Role of Bellcore	84-90
a. Positions of the Parties	84-88
b. Discussion	89-90
3. Information to be Loaded into the SMS	91-97
a. Positions of the Parties	91-95
b. Discussion	96-97
F. 800 Directory Assistance	98-106
1. Positions of the Parties	99-103
2. Discussion	104-106
G. Miscellaneous Issues	107-110
1. Application of ONA	107-108
a. Positions of the Parties	107
b. Discussion	108
2. Regulatory Flexibility Act	109-110
a. Positions of the Parties	109
b. Discussion	110
IV. Ordering Clause	111

I. INTRODUCTION

1. On January 14, 1986, we adopted a Notice of Proposed Rule Making[1] *(Notice)* to consider the long-term obligations of local exchange carriers (LECs) with respect to their provision of access to interexchange carriers (IXCs) for 800 service. The Bell Operating Companies (BOCs) and other LECs were then developing a "data base plan" for 800 access. The *Notice* tentatively concluded that this data base plan was superior to other forms of 800 access and that LECs should be required to implement that plan. In February 1988, we released a Supplemental Notice of Proposed Rule Making[2] *(Supplemental Notice)* seeking further information and comment on a number of issues relating to the data base plan.

2. The record compiled in this proceeding reveals that the data base plan would offer both advantages and disadvantages to 800 subscribers vis-a-vis the current "NXX" 800 access system. The advantages derive principally from the fact that with data base access, the first three digits of 800 numbers (following the 800 prefix) would no longer be uniquely associated with particular IXCs, as they are with NXX access. This "number portability" would promote competition in the 800 market by allowing current 800 subscribers to switch IXCs without abandoning their 800 number and new 800 subscribers to select an IXC to carry their traffic without being limited to the 800 numbers assigned that carrier. The disadvantages of the data base system derive principally from the fact that, at least in the near term, it would significantly increase post-dial delay for 800 calling, thereby degrading service quality. We conclude that, at the present time, the disadvantages of the data base system are so substantial that we cannot permit the LECs to withdraw the current NXX form of 800 access and replace it with data base access. The record

indicates, however, that it would be technically possible for LECs to offer both data base and NXX access, thereby giving IXCs and/or 800 subscribers a choice between the two access systems. For these reasons, we permit each LEC to implement the data base plan only if that LEC offers IXCs the option of retaining NXX access for some or all of their NXXs. If and when the level of access delay under the data base plan is substantially reduced, we would be willing, on appropriate petition, to permit LECs to discontinue NXX access.

3. In the meantime, we permit LECs to offer to IXCs, as optional access services, each of the vertical services LECs propose to provide with their data base systems. LECs should treat core CCS7 costs as common network costs and allocate these and 800-specific costs in accordance with existing rules. We also approve the use of existing separations procedures and categories but defer development of permanent access charge rules pending completion of our Rule Making in CC Docket No. 89-79.[3] LECs that will implement their data base systems prior to completion of this Rule Making, should seek a waiver of our Part 69 rules to permit the establishment of separate subelements within existing Part 69 elements for each data base service offered. In addition, we encourage parties to continue the progress they have made in resolving many of the issues pertaining to administration of the data base system, but direct LECs to accept Percentage Interstate Use (PIU) reports as the jurisdictional basis for assessing interstate access charges. And finally, we permit AT&T, at this time, to continue providing 800 Directory Assistance (DA) service, subject to tariffing and nondiscrimination requirements, but encourage parties to develop alternative solutions that might be preferable to this arrangement.

II. BACKGROUND

4. The term "800 service" describes an interexchange service in which subscribers agree in advance to pay for calls made to certain subscriber-designated numbers. The service is used primarily by businesses to provide potential customers and other persons a free and convenient means of contacting them. Subscribers may choose to offer 800 service on a nationwide basis, or they may limit their service to specific geographic areas.

5. Because the called party pays for an 800 call and selects the IXC that will carry the call, the LEC in whose area an 800 call originates cannot identify the IXC to which the call should be routed in the same manner as it identifies the IXC for non-800 calls - that is, based on the caller's choice of IXC, presubscribed or otherwise. Accordingly, local exchange access for 800 service must be handled differently from access for ordinary interexchange calls.[4] Indeed, from 1967, when AT&T first introduced 800 service, until late 1986, LECs were unable to provide access for 800 service to any IXC other than AT&T ("Other Common Carrier" or "OCC").

6. In late 1986, the BOCs and other LECs provided OCCs with 800 access for the first time through the so-called "NXX" screening methodology. Under this system, LECs identify the carrier to which 800 calls should be routed by reading the three digits that immediately follow the 800 prefix of the dialed number (the "NXX" digits).

7. Because the NXX screening methodology identifies the 800 carrier by the NXX digits, the system requires that particular NXXs be assigned to particular carriers. Consequently, under the NXX system, 800 subscribers cannot change carriers without changing their 800 number. In addition, subscribers that seek a particular 800 number must obtain their 800 service from the carrier to which the NXX digits in that number have been assigned. If the carrier does not offer 800 service in the subscriber's area, the subscriber will be unable to use the number it wants.[5] Moreover, to preserve for as long as possible the pool of available NXXs, the administrator of the NXX assignment process, Bell Communications Research (Bellcore), will not assign a new NXX to a carrier until the carrier has used 70% of the capacity on each of its existing NXXs. Thus, a subscriber may not use an 800 number beginning with an unassigned NXX unless the subscriber can find a carrier that is eligible for a new NXX and that agrees to request the NXX associated with that number.

8. The BOCs, along with some Independent Telephone Companies (ITCs), are currently developing common channel signaling networks based on the CCS7 protocol. These LECs propose to link their CCS7 networks with data bases containing 800 service information so that they may replace the NXX access system with a so-called "data base system" of 800 access. Under this data base system, information on the 800 carrier associated with each 800 number in service would be loaded into various regional data bases around the country.[6] LECs would then access these data bases through their CCS7 networks for routing instructions for each 800 call. The data bases would provide these instructions based on a ten-digit screening of the 800 number (the "800" prefix, plus the seven-digit number), as opposed to the six-digit screening on which the NXX system is based.[7]

9. Because the data base plan would permit ten-digit screening of the 800 number, it would allow number portability. This means that 800 service subscribers would be able to change carriers without changing their 800 number. In addition, subscribers would be able to select any 800 number not already assigned, without regard to NXX limitations, and to use this number with any carrier's 800 service, or use more than one carrier with the same number.

10. The LEC data base systems will also have other capabilities. For example, these systems could be used to: (1) determine whether the call has originated in a subscribed service area; (2) translate the 800 number into a POTS number; (3) vary the POTS translation, in accordance with customer instructions, so as to direct the routing of calls to different subscriber locations based on time of day, place of origination of the call, and other factors; (4) direct the routing of calls to different carriers based on these same kinds of factors; (5) determine the least cost carrier and direct the LEC to route the call accordingly; and (6) generate statistical information on the nature of a subscriber's 800 traffic.[8] The LECs generally propose to offer each of these services, except least cost routing, (hereinafter referred to as "optional" or "vertical" services) to 800 subscribers and/or carriers on an optional basis.

III. ISSUES

A. *Is the Data Base Plan in the Public Interest?*[9]

11. The *Supplemental Notice* reiterated the tentative conclusion in the *Notice* that the data base plan appears to offer substantial benefits to 800 subscribers. In particular,

we noted that the number portability made possible by the data base plan would appear to: (1) allow OCCs to compete on equal terms for AT&T's substantial embedded base of 800 subscribers; (2) allow all IXCs to offer the same 800 number possibilities to future 800 subscribers, including use of commercially attractive NXXs that are currently assigned to AT&T; (3) promote efficiency in the 800 interstate market by enabling customers to respond to price and service changes without changing their 800 number; and (4) promote participation of small, regional IXCs in the interstate market by enabling those IXCs to offer regional service to subscribers under the same 800 number that the subscribers use for calls originating from different areas.[10] We further noted that the ability of LECs to provide POTS translation for small IXCs would appear to enable small IXCs that cannot afford their own data base system to participate in the 800 market. We observed, however, that despite the apparent pro-competitive effects of the data base plan, some of the potential competitive suppliers of 800 service, such as MCI, appeared to be questioning the benefits of the BOC proposal. Accordingly, we asked for further information on the benefits of the data base plan, including the value of number portability to 800 subscribers and to the development of a competitive interstate 800 service market.

12. We also asked for further comment on the costs of the data base plan. Noting that in response to the *Notice*, parties provided little detailed information on the costs of implementing and operating this system of access, we requested further information and comment on these costs. We also sought comment on the extent of post-dial delay increases that would occur under the data base plan and the degree to which 800 subscribers would be sensitive to such increases.[11] Finally, we sought comment on whether, in light of these costs, we should require LECs that implement the data base plan to maintain NXX access, so as to offer subscribers or IXCs a choice of 800 access systems.[12]

1. *Positions of the Parties*[13]

a. *Benefits of data base plan*

13. Most parties responding to the *Supplemental Notice* agree that number portability represents a significant benefit of the data base plan.[14] They assert that many 800 subscribers use verbally significant 800 numbers or invest substantially in marketing their 800 numbers and are thus not able to change them except at considerable cost. These parties claim, further, that administrative costs may deter a subscriber from changing its 800 number, even if the number is not verbally significant or part of a marketing effort. BellSouth notes, as examples, that Whirlpool prints its 800 number on its consumer buying guides and on all its product use and care literature, warranty cards, and print ads, and that Clairol and Proctor and Gamble print their 800 numbers on their products.[15] The comments reflect a general consensus that because of this commitment of many 800 subscribers to their 800 number,[16] number portability would promote competition in the 800 market in the ways suggested in the *Supplemental Notice*.[17]

14. A number of LECs claim, further, that number portability would allow a more efficient use of the 800 Service Area Code (SAC) than does the NXX system. They state that as of February 1988, there were only 378 unassigned NXXs, and that Bellcore was assigning new NXXs at a rate of about ten per month. These LECs state that at this rate, the supply of NXXs will be exhausted within three years. In contrast, they claim, 88% of all 800 numbers are not currently being used.[18]

15. Although the parties generally agree that the principal benefit of the data base plan is number portability, some of them also cite other benefits. For example, some parties state that centralization of the ordering process under the data base plan would reduce administrative errors and make it easier for carriers to enter the 800 market.[19] CompTel states that its members have experienced problems in implementing NXX-based service because of the need to deal individually with all of the LECs.[20]

16. Some parties also cite the vertical features that might be available under a data base plan as a benefit of this form of access. Some LECs, for example, state that a POTS translation offering will enable small IXCs to enter the 800 market. Small IXCs agree that POTS translation will be useful to some IXCs; however, they indicate that, except perhaps for multiple carrier routing capability, the value to small IXCs of the vertical features may have been overstated in the *Supplemental Notice*.[21]

b. *Costs of the data base plan of 800 access*

17. Parties identify two principal costs of the data base plan: (i) the investment and expense required to develop, implement, and operate this form of access, and (ii) the increase in post-dial delay that would result from replacing NXX access with data base access.[22]

i. *Expense and Investment*

18. All of the BOCs filed projected revenue requirements for data base 800 access service.[23] According to these projections, the total annual interstate revenue requirement for 800 access service for the seven BOCs combined will be approximately $20 Million.[24]

19. These cost data are markedly different from those described by the parties prior to the *Supplemental Notice*.[25] The principal reason for this difference is that the BOCs now claim that their CCS7 systems, which had accounted for a substantial portion of 800 data base system costs, represent general network upgrades, much like the conversion to digital switching or optical fiber, the costs of which should be shared by all network users rather than included in the service-specific 800 access revenue requirement.

ii. *Post - dial Delay*

20. As noted above, the data base system would increase access time[26] for most 800 calls. Virtually all of the parties agree on the scope and duration of these increases. As described in the record, access time would depend upon the extent to which the LEC providing access has implemented CCS7 in its network. In general, there appear to be three possible scenarios. Initially, when most LECs have limited CCS7 capabilities, and these capabilities are confined to access tandems, the data base plan would increase access time for most 800 calls by either 5.5 or 7.1 seconds, depending on whether the carrier receives NXX access from an access tandem or end office. By 1990 or 1991, software will be available to enable LECs to use CCS7 signaling to interconnect with IXCs. As this capability is implemented, access time for 800 calls will be reduced by about four seconds (leaving a total increase of

1.5 to 3.1 seconds). Finally, when CCS7 is deployed in end offices, access time will be either slightly less or no more than it is now under the NXX system.[27]

21. Currently, LECs vary in their commitment to CCS7 end office deployment. Bell Atlantic states that it will deploy CCS7 capabilities in end offices serving 54% of its access lines by the end of 1989.[28] BellSouth also indicates that it will pursue an aggressive deployment schedule. By the end of 1989, it plans to have CCS7 capabilities in end offices serving 29% of its access lines.[29] On the other hand, Southwestern Bell, NYNEX, and PacTel state that they have not yet established a definite schedule for CCS7 end office deployment.[30] Among the ITCs, GTE and Cincinnati Bell indicate a commitment to deploying CCS7 at end offices. GTE states that by 1992, 70% of its access lines should be serviced by end offices with CCS7 capabilities. GTE states that this percentage will increase to over 90% by 1995.[31] Cincinnati Bell states that it will deploy CCS7 in its end offices in 1990.[32] In addition, ITCs participating in the U.S. Intelco/ITN network will apparently deploy CCS7 initially in their end offices.[33]

22. Most IXCs and users express considerable concern over the increase in access time that would result, at least initially, from the data base system. IXC and user comments propose various remedies to address this problem. AT&T, for example, urges us to prohibit implementation of the data base system until CCS7 is deployed in a significant number of LEC end offices nationwide.[34] AT&T does not specify the percentage of end offices that, in its view, should be equipped with CCS7 capabilities before abandonment of NXX screening, but notes that a relatively small percentage of LEC end offices service the vast majority of all access lines.[35] Teltec urges us to delay implementation of the data base plan until LECs have implemented CCS7 interconnection capabilities at their access tandems, thereby reducing, but not completely eliminating, the increase in access time.[36] Microtel, expressing concern that small OCCs, which must convince subscribers that small OCCs can provide high quality service, would be blamed by subscribers for the increased access delays, proposes a variation of Teltec's plan, in which data base access would be optional prior to deployment of CCS7 interconnection, except that AT&T would be required to use data base access for its frozen NXXs, and the BOCs would have to use data base access for all of their NXXs. CompTel and Cable & Wireless also support this plan.[37] MCI proposes that LECs abandon the data base plan and perform 10-digit screening on a switch-resident basis.[38] ALC proposes that LECs modify the architecture of the proposed data base system in a way that, it claims, would reduce access delays.[39] US Sprint proposes that LECs set aside a limited number of currently unassigned NXXs to accommodate 800 subscribers that are particularly sensitive to access delays.[40] On the other hand, Teleconnect opposes continuation of even a limited NXX regime. It states that the needs of specialized users, such as transation validators, should be addressed during the period prior to full CCS7 deployment through alternate solutions, such as 700 or 900 services, reverse billing arrangments, or other means.[41]

23. Most user comments also express considerable concern about the increased access delays that would occur under the data base plan.[42] DMA, for example, states that "[i]n many cases, delay in the completion of calls yields lost sales and/or increased customer dissatisfaction."[43] Similarly, Aeronautical Radio states that "delays will seriously inconvenience callers, thereby adversely affecting their perception of 800 Service and, consequently, the airlines' reservations services."[44] It adds, further, that 800 subscribers would incur additional costs if their customers abandoned and redialed calls as a result of access delays, since some LEC tariffs assess charges based on call "attempts" rather than completions.[45]

24. Parties that use 800 service in validating credit card and other transactions, object even more strenuously to the access delays that would occur under the data base plan. They state that transaction validation calls are of particularly short duration and that 5.5 to 7 seconds represents a large percentage of total call time for these calls.[46] Transaction validators state that these added delays would be unacceptable to merchants and consumers.[47] They also note that many point-of-sale terminals used to originate 800 calls to validation services are programmed to "time-out" after thirty seconds. NDC claims that it could not reprogram most of its terminals to change this "time-out" period without returning the terminals to the manufacturer's factory, which would necessitate an interruption in service.[48]

25. Citing these delays, as well as other concerns about the data base plan, a number of users urge us to require LECs that implement the data base system to retain NXX access as an optional offering. They propose that we establish this option by dedicating a second SAC, such as 400, to toll-free service.[49] They claim that this procedure would allow subscribers that are particularly sensitive to post-dial delay to avoid the increase in access time that will occur under the data base plan. Such parties claim, as well, that users that do not value number portability should not have to pay the higher access costs that will be charged under the data base plan.[50] In addition, they argue that a competitive alternative to the data base plan would ensure that the price of access under this plan is reasonable, and, specifically, that the BOCs do not shift costs from the optional features to basic access service.[51] In the alternative, CBCHA/CCTU propose that we require the BOCs to postpone implementation of the data base plan until CCS7 technology has been sufficiently deployed to eliminate, or at least significantly reduce, the increased access time associated with this system.[52]

26. LECs argue that the increased access delays under the data base plan warrant neither rejection of the data base plan nor retention of a long-term NXX option. Claiming that callers have historically adjusted to increases in call set-up time in the past,[53] they argue that the increases that would occur under the data base plan would not pose a problem for most traditional 800 service applications.[54] BellSouth and NYNEX assert that 800 callers are already tolerant of post-dial delays, since average 800 call set-up times currently vary by as much as seven seconds among IXCs.[55]

27. Most LECs admit that the initial 5.5-7 second increase in access time might pose a problem for transaction validation services but argue that these services represent a small percentage of total 800 traffic.[56] These LECs also argue that there are ample ways in which transaction validators could be accommodated within the context of a general data base offering. They suggest, for example, that LECs retain a limited, interim NXX option, similar to that proposed by AT&T prior to the *Supplemental Notice*,[57] until CCS7 interconnection capabilities have reduced call set-up time to levels closer to NXX levels.[58] They suggest, alternatively, that data base access be op-

tional to IXCs until CCS7 interconnection is available.[59] A number of ITCs also favor this approach, or some other transition to the data base plan, as a means of providing ITCs with sufficient time to make the necessary arrangements to participate in the data base plan.[60]

28. LECs uniformly oppose retention of a long-term NXX access option in the 800 SAC. Although they admit that, as a technical matter, NXX and data base access are not incompatible,[61] LECs argue that dual systems will be unnecessary after LECs have implemented CCS7 interconnection capabilities. They also argue that if we permit IXCs to choose between data base and NXX access, AT&T will have a strong incentive to choose NXX access, thereby denying most 800 subscribers and OCCs the benefits of number portability.[62] LECs state that under these circumstances, the data base system would lose its viability.[63]

29. LECs also oppose the suggestion of some users that we retain NXX access in a separate SAC (*e.g.*, 400) from data base access. They claim that if data base access is provided in the new SAC, subscribers will be forced to change SACs in order to obtain number portability.[64] This, they claim, would defeat one of the primary purposes of the data base plan.[65] LECs also oppose retention of an NXX option in a new SAC on the ground that this would create a submarket of noncompetitive 800 services.[66]

30. Many OCCs likewise oppose a long-term NXX option on the ground that NXX access denies them the ability to compete for AT&T's embedded customer base.[67] In addition, the Florida PSC opposes a long-term NXX option, arguing that the data base system should be fully utilized so as to minimize unit cost.[68]

c. *Alternatives to the data base plan*

31. As noted above, virtually all of the parties view number portability as an important benefit of the data base plan. MCI and ALC, however, argue that the BOCs' data base plan is not the only way to provide number portability, and each proposes an alternative system.

32. MCI proposes that LECs be required to perform ten-digit screening of 800 calls on a switch-resident basis - *i.e.*, in their stored program controlled switches. It claims that the data base represents "overkill" and that LEC switches could be easily modified to perform ten-digit screening instead of six-digit screening.[69] Indeed, it suggests that the memory capacity required to house the total universe of 800 numbers and carrier identification codes in a stored program controlled switch would be twenty megabytes, which is less than the capacity of a common desk top personal computer.[70] MCI claims that the BOCs have developed an unnecessarily sophisticated access system because they seek to use this system for a variety of intraLATA services, while saddling IXCs with the costs of acquiring these service capabilities.

33. In reply, the BOCs take sharp issue with MCI's assertion that they could provide ten-digit screening with their existing switches at very little additional cost. PacTel, for example, states that MCI confuses computer or switch memory with disk storage capacity. PacTel states that in most cases, call processing programs and routing tables are contained within switching random access memory (RAM) and not within disks, as MCI assumes. To expand RAM by even ten megabytes, it states, would be cost prohibitive, if not impossible.[71]

34. BellSouth and Southwestern Bell also dispute MCI's claims regarding the cost of deploying ten-digit screening on a switch-resident basis. BellSouth states that MCI's proposal would require a "fundamental change in the generic software, memory allocation, and translation tables of the switch equipment,"[72] while Southwestern Bell states that implementation of MCI's proposal would cost between $200,000 and $500,000 per end office or access tandem.[73]

35. The BOCs also criticize MCI's proposal on the ground that it would create "an administrative nightmare." They note that if this proposal were implemented, every 800 service order or modification thereof would have to be simultaneously entered into every switch of every LEC providing 800 access service. The BOCs claim that this would not only result in increased routing errors, but would require each LEC to hire substantial additional staff to handle these administrative requirements. Southwestern Bell, for example, claims that since there are over 500,000 working 800 numbers, it could expect 5000 service orders per day (assuming a 1% service order rate). Assuming that each service order required five minutes, to input these service orders into each of its 600 end offices, it states, would require 250,000 manhours per day, or 31,250 new employees.[74]

36. ALC also proposes an alternative methodology for providing ten-digit screening. ALC does not object to a data base system, *per se*, but objects to the architecture of the BOCs' plan, specifically, what it describes as the bundling of ten-digit screening capabilities with other capabilities. ALC claims that this architecture will give the LECs an advantage vis-a-vis other carriers that have their own data base systems and force all carriers to purchase optional features from the LECs.[75] ALC states that the LECs will be able to perform optional services during the same data base query in which the LEC performs carrier identification functions, while IXCs will have to initiate a separate data base query. ALC proposes that the BOCs separate the ten-digit screening functionality from the vertical functionalities. ALC's plan would create a separate data base for ten-digit screening, which would be administered by a third party, and satellite data bases, controlled by LECs and IXCs, which would perform the vertical functionalities. The third-party data base would communicate directly with the appropriate satellite data base while simultaneously returning carrier identification information to the LEC SSP.[76] According to ALC, this arrangement would create a level playing field for the vertical functionalities, and also reduce call set-up time. ALC states that its proposal could be implemented in two years.

37. The BOCs deny that ALC's proposal could be implemented in two years. They state, for example, that because of the extensive interconnections between networks required under this system, extensive security arrangements would have to be implemented. Some also state that it would not be possible with current technology for the data base simultaneously to return a signal to the SSP and another data base.[77] The BOCs also claim that ALC overstates the benefits to be derived from this architecture. They state that a data base query requires only 1.5 seconds, so that the LEC advantage at not having to initiate a second query to the data base is small.

2. Discussion

38. The record compiled in this proceeding reveals that the data base system would offer both advantages and disadvantages as compared with the NXX system. On the one hand, the record confirms our tentative conclusions in the *Notice* and *Supplemental Notice* that the number portability made possible by the data base plan would allow 800 subscribers greater flexibility in choosing 800 numbers and carriers and also help promote competition in the 800 market.[78] While no party attempts a precise quantification of these benefits in monetary terms, the vast majority of commenters agree that these benefits are real and that number portability is a desirable component of a competitive 800 service market. On the other hand, the record demonstrates that until CCS7 capabilities are widely deployed, the data base system would significantly increase access time for 800 calls.[79] A large number of parties express serious concerns about these increased access delays. While we wish to promote competition and customer choice in the 800 market, we are unwilling to mandate an 800 access system that would degrade the quality of 800 service in this manner. The public interest would not be served by permitting LECs to discontinue existing 800 access services in such circumstances.

39. The record establishes that it would be possible for LECs to offer data base and NXX access simultaneously without materially affecting the technical quality of either service. Moreover, the record indicates that some IXCs might prefer data base access, even if AT&T chooses NXX access for all of its NXXs. For example, small IXCs may choose data base access so as to facilitate sharing arrangements with other IXCs or to purchase vertical features. Other IXCs may choose data base access so that they can avoid the administrative costs of ordering NXX access.[80] In addition, IXCs may choose data base access for technical reasons.[81] Under the circumstances, we find that, at least for now, dual offerings would best serve the public interest. Accordingly, we permit the LECs to implement the proposed data base plan, with some modifications, but we require LECs that do so to continue offering NXX access.[82] Pursuant to this NXX option, each carrier may choose either NXX or data base access for each of its currently assigned NXXs. In addition, as carriers are assigned new NXXs, carriers may dedicate these NXXs to either system.[83] If and when the LECs' deployment of CCS7 is sufficient, so that the level of access delay associated with the data base system is substantially reduced, we will, upon appropriate petition, permit LECs to discontinue NXX access. Our current expectation is that we will be able to grant such a petition when CCS7 is deployed to access tandems and, on a nationwide average basis, to end offices accounting for eighty percent of originating 800 traffic.

40. We do not require LECs to implement the MCI or ALC proposals. MCI's proposal appears to be fraught with problems. The BOCs claim that it would be more expensive to implement than the data base plan, and clearly it would be much more difficult and expensive to administer. Indeed, no other party supports MCI's claim that ten-digit screening could feasibly be performed on a switch-resident basis. It also appears that ALC's proposal is not technically possible at this time. Nor is it clear that this proposal would adequately address the service degradation problems associated with the data base system. Accordingly, although LECs are free to explore with ALC and other IXCs a reworking of the data base system architecture along the lines proposed by ALC, we do not require LECs to implement ALC's proposal.

B. *Obligations of ITCs*

41. The *Notice* invited comment on whether we should require ITCs to implement the data base plan. We also sought comment on whether we should establish an implementation schedule for BOCs and ITCs.[84] The *Supplemental Notice* invited further comment on these issues. We also invited comment on whether we should take action to facilitate ITC participation in the data base plan so as to ensure the ubiquitous implementation of this plan.[85]

1. Positions of the Parties

42. The parties generally agree that, if the data base plan replaces the NXX system, it must be implemented on a ubiquitous, or near-ubiquitous, basis.[86] They state that carriers are able to offer nationwide 800 service under the NXX plan and that carriers should not lose the ability to do so under the data base plan. Some parties state that if we permit the BOCs to implement the data base plan, we should require the ITCs to participate in this plan so as to ensure the continued availability of 800 access service on a ubiquitous basis.[87] Some of these parties also ask us to establish a timetable for ITC participation in the data base plan so as to ensure a simultaneous, nationwide cut-over to this plan.[88]

43. Most LECs argue that it is not necessary to require ITCs to implement the data base plan. Citing a USTA survey, which found that, as of November, 1987, LECs representing 98.7% of all access lines intended to participate, they argue that even without our intervention, market forces will result in nationwide participation in this plan.[89]

44. A number of ITCs filed comments (either singly, jointly, or through consultants) uniformly expressing enthusiasm about CCS7 capabilities generally and the data base plan specifically. Some ITCs state, however, that they were largely excluded from the early planning stages of this system and have thus not finalized their plans for participating in it. They mention several options available to them and claim that the choice among these options affects not only their mode of providing 800 access service, but also CCS7 services generally.[90] ITCs ask us to refrain from establishing an implementation timetable, or, at the very least, to establish one that gives ITCs sufficient time to evaluate their options and implement their plans in the most efficient way possible.[91]

2. Discussion

45. Arguments that we should require LECs to implement the data base plan are premised on the assumption that the data base plan will replace NXX access service. Because we require LECs that implement the data base plan to retain NXX access, the data base plan will not compromise the availability of nationwide 800 access service, even if some LECs do not choose to participate in it.[92]

C. *Vertical Features*[93]

46. The *Supplemental Notice* also invited comment on the benefits of each of the vertical features that the BOCs propose to offer with their data base systems.[94]

1. Positions of the Parties

47. LECs argue that we should permit them to offer all of the proposed vertical features. They argue that it is efficient for LECs to validate 800 calls so that unauthorized or misdialed calls may be blocked at the earliest possible point in the network.[95] LECs argue, as well, that the availability of POTS translation as an 800 access service offering will make it easier for small IXCs to participate in the 800 service market by reducing entry barriers.[96] United claims that at least two IXCs in its territory have expressed an interest in this service.[97]

48. The LECs also contend that they should be permitted to offer alternate POTs translation and multiple carrier routing. They argue that a LEC-provided alternate POTS translation service will benefit 800 subscribers by providing the subscribers with a competitive alternative to IXC offerings of this service. LECs also contend that LEC provision of this service will lower entry barriers for small IXCs by allowing such IXCs to offer some of the features that the larger IXCs can offer.[98] LECs argue that multiple carrier routing will allow subscribers to economize their 800 service by dividing their 800 traffic volume among a number of different IXCs. In addition, claiming that IXCs would be unlikely to offer multiple carrier routing themselves because that would require an IXC to route 800 traffic to its competitors, LECs argue that we should allow LECs to offer this service directly to 800 subscribers.[99]

49. IXCs are divided as to whether LECs should be permitted to offer the proposed vertical features. Most small IXCs generally agree that, subject to appropriate cost allocation rules, LECs should be permitted to offer the proposed vertical features on an optional basis.[100] However, except for multiple carrier routing, small IXCs do not appear to view these options as essential to their participation in the 800 market. Microtel and CompTel, for example, state that most switch software could accommodate POTS translation functionalities quite easily.[101] On the other hand, many small IXCs view multiple carrier routing as critical to the ability of regional carriers to participate in the 800 market.[102]

50. AT&T, MCI, and ALC argue that we should prohibit the BOCs from performing any vertical features, except for call validation, on interexchange traffic.[103] Those IXCs contend that IXCs can perform POTS translation without a substantial investment.[104] MCI argues, further, that even if POTS translation required a substantial investment, it is not the province of the LECs to assume that investment on behalf of IXCs that cannot afford it themselves.[105]

51. MCI, AT&T, and ALC also argue that IXCs compete for 800 subscribers largely by offering features, such as POTS and alternate POTS translation, and that if the BOCs are permitted to provide these services with their data base systems, IXCs will lose their incentive to innovate and design new service offerings.[106] ALC elaborates, arguing that the BOCs have designed their data base systems so as to give themselves an advantage over IXCs in providing optional services, since the BOCs can perform these functions during the same data base lookup in which they perform ten-digit screening. ALC asserts that if BOCs are permitted to provide optional services under the current data base system architecture, the BOCs will become the sole providers of 800 vertical features, and IXCs will be reduced to a pipeline function in the 800 market.[107] Similarly, MCI states that the bundling of the vertical features with ten-digit screening will enable the BOCs to shift costs from the former to the latter, thereby giving BOCs an insurmountable advantage in the optional services market.[108]

52. Finally, AT&T argues that multiple carrier routing for all practical purposes is no different from least cost routing. AT&T claims that if the BOCs are permitted to offer multiple carrier routing, BOCs will inevitably market this service by working with customers to develop an economical service package. AT&T claims that this Commission should thus prohibit the BOCs from offering multiple carrier routing.[109]

2. Discussion

53. We conclude that LECs should be permitted to offer each of the proposed vertical features to IXCs as part of 800 access service, but not to IXC's 800 service customers.[110] We address each of the proposed services, in turn, below.[111]

54. The least controversial of the proposed services is call validation. Indeed, no party opposes LEC provision of this service. Moreover, efficiency goals will be furthered if the LECs are permitted to block unauthorized 800 calls before sending them to the IXC. Therefore, we permit LECs to offer this service to IXCs.

55. The record now indicates that while some IXCs might prefer to purchase POTS translation capability from the LECs, POTS translation does not represent a significant barrier to entry, even for small IXCs. At the same time, however, the record reveals no compelling reason to preclude the LECs from offering POTS translation as an access service. While IXCs argue that they compete on the basis of which vertical features they can offer, it is highly unlikely that basic POTS translation represents a significant source of competition. Indeed, POTS translation capabilities are both invisible to the 800 subscriber and, from a practical standpoint, a virtual necessity for IXCs wishing to enter the 800 market. Permitting the LECs to provide this service to IXCs may make it cost-effective for some IXCs to enter the 800 market that would not have done so otherwise, and for that reason, we see no reason to withhold this permission.

56. Alternate POTS translation presents more difficult issues. First, the BOCs propose to offer this feature, not only to IXCs, but to IXC customers, as well. Second, unlike basic POTS translation, alternate POTS translation is not a virtual prerequisite for participating in the 800 market. Rather, it is the kind of service option that IXCs currently offer to obtain a competitive edge in this market.[112] Third, we are cognizant of IXC arguments that the LECs' data base systems provide the LECs with at least a small advantage over IXCs in the offering of this and other optional services. After balancing the various considerations, we conclude that LECs should be permitted to offer alternate POTS translation, but only to IXCs, not to interstate 800 service subscribers directly. The availability of this service from LECs should not only provide competitive alternatives to IXC offerings of this service, it should increase competition in the 800 market generally by enhancing the position of small IXCs.[113] Moreover, we are not convinced that the 1.5 additional seconds required for an IXC to query its own data base, in lieu of purchasing alternate POTS translation from a LEC, will preclude IXCs from using their own data base systems if they have

them, or provide IXCs that purchase alternate POTS from a LEC with a significant advantage over IXCs that use their own system to provide this service.

57. Nevertheless, we do not permit LECs to sell alternate POTS translation service to 800 service subscribers directly. This vertical feature is properly part of 800 access service. In other contexts, we have generally limited LECs to selling switched access services and features to IXCs and other purchasers of interstate access and not to the customers of IXCs or of other service providers.[114] We find that similar limitations should apply here. The provision of alternate POTS translation by a LEC to an IXC's subscriber would potentially interfere with the relationship between the IXC and its customer. In addition, permitting 800 subscribers to order alternate POTS service from a LEC could potentially compromise IXCs' ability to manage traffic flow over their own networks.[115]

58. Finally, we permit the BOCs to provide multiple carrier routing capabilities with their data base systems - *i.e.*, we permit the BOCs to route different calls to different carriers based on specified factors. However, we prohibit the BOCs from offering this capability directly to 800 subscribers. As we noted above, BOC optional services should not be a vehicle for the BOCs to place themselves between IXCs and IXC customers. Moreover, such an offering would unduly disrupt the IXCs' ability to control their own networks. Subscribers that wish to take advantage of BOC multiple carrier routing capabilities will be free to design their own service and order it from whichever IXCs they choose. In addition, one or more IXCs will be free to design an 800 service for a prospective customer and order the necessary "piece-parts" of this service from other IXCs on behalf of the customer. Indeed, contrary to the BOCs' assertions, regional carriers will have every incentive to market multiple carrier routing to customers that seek nationwide 800 service.

D. *Cost Issues*

59. In addition to seeking information on the overall costs of the data base system, the *Supplemental Notice* also invited comment on how those costs should be recovered. Specifically, we invited comment on the appropriate accounting, separations, and access charge rules for 800 access service. We tentatively concluded that we should establish a separate Part 69 800 access element, with subcategories for each of the optional features, to which costs would be assigned on a fully distributed basis. We also endorsed interim accounting treatment prescribed by the Common Carrier Bureau (the "Bureau") for data base system costs.[116]

1. *Positions of the Parties*

a. *Identifying 800 Access Costs*

60. The comments reveal a broad consensus that CCS7 costs should be treated differently from costs LECs incur for the purpose of adapting and using their networks to provide 800 access service.[117] Parties argue that CCS7 represents a general network upgrade that will not only allow LECs to introduce a wide range of new services,[118] but will also improve the efficiency of existing LEC services. LECs state, for example, that CCS7 will offer trunking efficiencies by enabling them to achieve faster call set-up time than is possible with existing multi-frequency (MF) signaling and by enabling carriers to signal ahead to ensure a clear path before establishing a voice channel.[119] The BOCs also note that many of the Basic Service Elements (BSEs) necessary for their implementation of Open Network Architecture (ONA)[120] require CCS7 capabilities.[121] Parties, including most commenting IXCs, argue that, insofar as CCS7 will replace and improve upon current interoffice signaling systems, core CCS7 costs should be recovered from all network users, and that only those costs that are incurred specifically for 800 access service should be included in the 800 access revenue requirement.[122]

61. ALC, on the other hand, opposes the apportionment of any CCS7 costs to existing general network cost categories, arguing that such an apportionment would result in the cross-subsidization of some services by others and the jurisdictional misallocation of CCS7 costs.[123] ALC urges us to establish "SS7/STP/SCP/SSP-specific" cost allocation rules and rate elements and proposes that costs be assigned to these elements based on the relative number of weighted queries that each service and/or jurisdiction generates.[124]

62. LECs agree generally, but not completely, on which cost components should be included in the data base system revenue requirement and which should be treated as core CCS7 costs.[125] They agree, for example, that SCPs[126] and CCS7 links both between SCPs and STPs and between the SMS and SCPs are primarily 800 service-specific plant.[127] In addition, LECs agree that payments to the SMS should be included in their 800 data base system revenue requirement. However, they apparently do not agree on the proper treatment of SSP software costs. US West, BellSouth, and Bell Atlantic would include SSP software costs in the 800 access rate element. In addition, NYNEX, noting that its SSP software will support CCS7 interconnection for some non-800 services, claims that 80% of these costs should be considered 800-related.[128] On the other hand, Southwestern Bell, PacTel, and Ameritech do not distinguish between SSP hardware and software costs, and thus apparently consider SSPs to be strictly core CCS7 plant. LECs generally agree that other components of their data base systems, including SSP hardware, STPs, and signaling links between their SSPs and STPs represent core CCS7 plant.

63. Few IXCs and users comment on whether LECs properly identify 800 access costs. AT&T asks us to clarify that the appropriate components of data base system costs include the SMS, SCPs, and the data links between them and between SCPs and STPs.[129] US Sprint also requests that we specify the costs that should be included in the 800 data base revenue requirement, although US Sprint does not take a position on precisely which cost components should be included in this revenue requirement.[130]

b. *Accounting Treatment*

64. Most parties agree that data base system costs should be accounted for under the existing Uniform System of Accounts (USOA) prescribed in Part 32 of our rules.[131] They argue that there is nothing inherent in the data base system that warrants a departure from normal accounting procedures.[132] Generally, LECs propose to assign costs associated with the SSP, SCP, STP and trunk rearrangements to switching accounts (2210-2212 for investment, 6210-6212 for expense).[133] They seek to assign the costs of CCS7 data links either to cable and wire facility accounts (2410) or to circuit equipment accounts

(2232).[134] They assign costs associated with the SMS primarily to general purpose computer accounts (2124 or 6124) and information management accounts (6724).[135]

65. Several LECs object to the accounting treatment prescribed by the Bureau and endorsed in the *Supplemental Notice* for data base system costs incurred prior to implementation of these systems.[136] These LECs argue that while it is proper for capital costs of construction that are not expected to be completed witin one year to be assigned to account 2004, costs related to construction that is expected to be completed within one year should be included in account 2003.[137] They state, further, that there is no basis under Part 32 for deferral of expenses to account 1439. This account, they state, is for costs such as "preliminary surveys, plans investigations, etc., made for construction projects under contemplation," while the data base system is far beyond that stage. They note that placing data base system expenses in account 1439 denies carriers not only current cost recovery, but an opportunity to earn a return on the deferred amount as well. LECs state that data base system expenses relate to actual investment and imminent services and thus should be included within a carrier's revenue requirement.[138]

c. Separations treatment

66. Most parties agree that the data base system would not require separations changes.[139] They argue that establishing new separations rules for CCS7 and/or 800 data base service would be at odds with recent efforts of this Commission and Federal/State Joint Boards to streamline the separations rules. They also note that AT&T introduced its CCIS network without separations changes.[140]

67. Michigan, California, and NARUC, however, urge us either to establish a new Joint Board to consider separations issues implicated by the the data base systems or to refer these issues to the Joint Board that was considering the separations treatment of "mixed use" special access lines.[141] Noting that the Docket 80-286 Joint Board addressed the separations treatment of WATS access lines in that proceeding, they argue that WATS service is akin to 800 service, and that the separations issues for these services should accordingly be considered together. In reply, some LECs argue that special access services, such as access for WATS, raise completely different separations issues from 800 data base service.[142] NYNEX, for example, argues that existing separations rules would not misallocate 800 data base costs in the same way that current procedures misallocate mixed use special access costs.

68. US Sprint, MCI, Teleconnect, and Cincinnati Bell also advocate special separations treatment of data base system costs. US Sprint claims that existing separations rules misallocate 800 access costs since these rules result in a 20-40 percent interstate allocation, while 70-80 percent of 800 messages are interstate. Sprint recommends that the 800 costs be allocated between jurisdictions based on 800 call attempts.[143] MCI, claiming that LECs have developed vertical features and capabilities primarily for their own intraLATA 800 service, argues that all costs of developing and providing these features should be allocated to the intrastate jurisdiction before the separations process is applied to the remaining costs.[144] Teleconnect recommends that a proportional "length of field" allocator be used to allocate 800 access costs.[145] Cincinnati Bell, claiming that over 90% of its originating 800 messages are interstate, urges us to assign all 800 access costs to the interstate jurisdiction.

d. Part 69 rules

69. Most parties argue that this Commission should not establish a new Part 69 cost element for the recovery of CCS7 or 800-specific costs. Instead, they argue that existing Part 69 access elements - specifically, the local switching and local transport elements - are well-suited for the recovery of core CCS7 costs and that we should permit the establishment of subelements within these categories for the recovery of the 800-specific costs on an unbundled basis.[146] These parties claim that a new cost element for 800 access service is unnecessary in light of the small size of the interstate 800 revenue requirement.[147] They also claim that a new cost element would needlessly complicate the Part 69 costing process at a time when this Commission has been trying to simplify these rules and would establish a precedent that each new CCS7-based service requires its own cost element. Such a precedent, they state, would greatly delay the availability of new services to the public. The LECs claim that 800 access costs can be more efficiently unbundled from other access costs and from each other by providing LECs with the flexibility within the existing Part 69 framework to establish appropriate subelements for these and other CCS7 services.[148]

2. Discussion

70. A substantial majority of the parties that address cost issues, including LECs, IXCs, and users, argue that CCS7 costs should be treated differently from costs associated specifically with 800 access service under the data base system. We agree. CCS7 represents a new network infrastructure that will not only support a number of new interstate and state services, but will also increase the efficiency with which LECs provide existing services, basic and non-basic.[149] As such, CCS7 represents a general network upgrade, the core costs of which should be borne by all network users. Accordingly, we will treat as the costs of providing data base access service only those costs that are incurred specifically for the implementation and operation of the data base system, and we direct the LECs to establish rates for data base access based only on these specific costs.[150] The costs of CCS7 components that will be used to support other services should be apportioned in accordance with existing rules for other network services.[151]

71. We also agree with parties that argue that existing accounting provisions suffice for the capital investment and expense associated with the data base systems and CCS7 networks. Our new Part 32 rules incorporating the USOA were designed with the expectation that they would accommodate the implementation of new services and the update of existing technology. Indeed, we specifically rejected a "service costing" approach to accounting during our revision of these rules on the ground that it was neither feasible nor desirable to combine a financial accounting system with a cost accounting system because of their fundamentally different objectives.[152] We find nothing unique in CCS7 or data base system costs that warrants a deviation from these rules. Indeed, to the contrary, our new Part 32 rules were adopted after AT&T already had its common channel signaling system and associated data base systems in place. Therefore, we find

that the USOA will accommodate the implementation of CCS7 and data base systems without any special accounting changes or provisions.

72. Although we do not specify in detail the appropriate accounting treatment for all data base system costs, we do address one particular accounting issue. As noted above, several LECs assert that assignment of data base system expenses incurred prior to system implementation to Account 1439 (Other deferred charges), as required by the Bureau and the *Supplemental Notice*, is inappropriate. At the time we prescribed this treatment for data base system expenses it appeared that these expenses would be substantial in amount. In light of the cost data submitted in response to the *Supplemental Notice*, we now conclude that data base system expenses should be booked as incurred in accordance with normal normal accounting procedures. LECs should report to the Bureau all data base system expenses previously accumulated in Account 1439, and we delegate authority to the Bureau to determine the appropriate accounting treatment of these balances.[153]

73. Insofar as we find that existing Part 32 categories appropriately classify data base system and CCS7 costs, we also find that existing separations categories suffice for these costs. As discussed above, we conclude that CCS7 represents a general network upgrade that will be used for a wide variety of both intrastate and interstate services. Current separations rules are designed to provide the proper separations treatment of the costs of such network facilities. Furthermore, the record reveals that the costs associated specifically with 800 data base access will be relatively modest, involving an unseparated annual revenue requirement of less than $100 million for the seven BOCs combined. In light of the size of this revenue requirement, we are not persuaded that separations changes are necessary, particularly in light of the recent efforts of this Commission and Joint Boards to simplify the separations rules.[154] Finally, we note that the costs of AT&T's CCIS network and related data bases have been separated under existing separations procedures, and no party presents any reason why CCS7 and data base costs require different separations treatment for the BOCs than for AT&T. For these reasons, we believe that it is unnecessary to develop unique separations treatment of 800 access costs.

74. Finally, we agree with commenters that argue that LECs should offer data base access through separate subelements for 10-digit screening and the various vertical features. We note that we have adopted today a Notice of Proposed Rule Making to consider Part 69 rule changes that would permit LECs to establish subelements of existing Part 69 rate elements for new access services that will be offered on an unbundled basis.[155] While the principal focus of this Rule Making is on the BSEs that the BOCs will offer pursuant to our ONA requirements, the rules established therein may also create a framework for LECs to establish subelements for new access services, such as 800 data base access, that we permit or require to be offered on an unbundled basis. Therefore, we do not adopt specific Part 69 rule changes governing 800 access service at this time. However, as discussed above, we clarify that LECs must develop rates for 800 data base access based only on their data-base-specific costs. LECs that seek to implement their data base systems prior to completion of this Rule Making should file petitions for waiver of our Part 69 rules to establish separate unbundled subelements, consistent with the principles stated herein, for basic data base access and each of the various vertical features.

E. *Administrative Issues*

75. The *Supplemental Notice* also invited comment on issues relating to administration of the data base plan. Specifically, we invited comment on: (1) whether BOCs should be permitted to accept orders for 800 service (or changes to an existing service) directly from 800 subscribers, or otherwise act as a subscriber's point of contact with respect to such orders; (2) whether Bellcore should be permitted to administer the assignment of 800 numbers or other SMS functions; and (3) the type of information that IXCs should be required to input into the SMS.[156]

1. *Service Order Issues*

a. *Positions of the Parties*

i. *Customer Point of Contact*

76. DMA states that customers should be able to place orders for 800 service with a LEC or IXC.[157] On the other hand, several IXCs, including ALC, MCI, USTS, Teleconnect, and Comptel, argue that customers should be required to place interLATA 800 service orders with an IXC.[158] They argue that if BOCs are permitted to accept such orders, IXCs will lose control over their networks, including their ability to ensure that adequate facilities are made available for each subscriber's 800 traffic.[159] ALC and MCI, in particular, emphasize this issue, asserting that 800 service requires particularly careful network planning by IXCs since underestimation of a subscriber's peak 800 traffic could result in blocking within the 800 carrier's network.[160] ALC contrasts other switched access services, where the facilities a subscriber orders act as a bottleneck that limits the amount of traffic entering the network, and thereby prevents blocking that will affect other subscribers.[161]

77. The BOCs initially took issue with the IXCs on this point, arguing that LECs already accept and implement orders for other switched access interLATA services and should be permitted to do so for 800 service as well.[162] However, the BOCs have now apparently modified this position. Thus, in an *ex parte* letter, filed December 27, 1988, NYNEX states that the BOCs will not accept orders for new interLATA 800 service unless they are authorized to do so by the requested IXC.[163] NYNEX states that absent such authorization, BOCs will refer customers seeking interLATA 800 service to an IXC. NYNEX states, however, that BOCs that are designated the "Responsible Organization" (RespOrg) for a particular 800 service order will accept and input service order changes from existing 800 subscribers. According to NYNEX, these practices are consistent with current practices for 800 NXX service.

ii. *SMS Access by IXCs*

78. IXCs argue that the IXCs should receive direct SMS access that would permit them, without restriction, and subject to appropriate security measures, to search for and reserve available 800 numbers, input service information, and otherwise revise and manage their customer records.[164] In addition, IXCs state that we should ensure that IXCs receive the same SMS access as LECs and on the same terms and conditions.[165] According to US Sprint, these and other issues relating to SMS access, such as whether all IXCs in a shared 800 service will be able to review the SMS record associated with that service, are currently being negotiated in the Ordering and Billing Forum (OBF).[166]

79. The BOCs claim that they have accommodated IXC concerns about SMS access. In the NYNEX letter, NYNEX elaborates, providing details of the arrangements which, it states, reflect agreement through the OBF. NYNEX states that any carrier -- whether that carrier is a LEC or an IXC -- will be able to purchase direct access to the SMS for 800 number search and reservation functions. In addition, it states, any carrier that is designated by the subscriber as the RespOrg for a particular 800 service order will be able to purchase access to the SMS records associated with that order, including the ability to originate or modify the service record. According to NYNEX, these two levels of SMS access will be made available to IXCs and LECs on the same terms and conditions.[167]

80. NYNEX states that the RespOrg will be, in each case, the entity that inputs the initial customer account record into the SMS. It states that each 800 subscriber will be able to choose an IXC or LEC as its RespOrg or to purchase SMS access and serve as its own RespOrg. In either case, the RespOrg will be the only entity with the ability to change the subscriber's 800 service record in the SMS.[168] NYNEX states that the designation of a single RespOrg for each subscriber is necessary to protect the confidentiality of proprietary subscriber records and prevents operational problems that could arise if multiple parties could change a subscriber's records.

iii. *Subscriber Access to SMS*

81. As noted above, the BOCs propose that 800 subscribers be permitted to purchase SMS access and serve as their own RespOrg. In addition, even if a carrier is designated as the subscriber's RespOrg for general purposes, the BOCs propose that subscribers be permitted to purchase limited SMS access that would be associated strictly with vertical features. For example, if end users were permitted to purchase alternate POTS tranlsation service, end users could use this limited SMS access to alter the routing of calls among various locations without carrier intervention. BOCs state that subscribers to IXC 800 services would benefit from the flexibilities allowed by this capability.

82. Several IXCs oppose subscriber access to the SMS. They express concern that such access would impede their ability to manage their networks and would result in increased blockage of 800 calls.[169] Claiming that these concerns are unwarranted, Bell Atlantic notes that subscribers of other services, such as ordinary Message Toll Service (MTS) can redirect traffic without IXC intervention through access code dialing.[170]

b. *Discussion*

83. It appears that the industry has made considerable progress in resolving many of the service order/SMS issues arising from the LECs' use of their data base systems. Thus, LECs state that they will not accept orders for interLATA 800 service from 800 subscribers directly, unless they are authorized to do so by the IXC that will carry the traffic. In addition, LECs state that they will provide IXCs with direct, on-line SMS access on the same terms on which such access will be made available to LECs. To the extent that contested issues remain, we believe that the best course at this time is to allow these inter-carrier discussions to continue. In our view, such a process has a better prospect of achieving an efficient result that serves the interests of all parties than would a solution imposed by regulation. We note that to the extent IXCs object to the administration of the data base plan, they may choose to retain NXX access, and we anticipate that this option will encourage LECs to accommodate IXC concerns about customer control and traffic management. Finally, of course, we remain open to petitions asking us to address administrative issues that are not resolved through industry discussions or that are not resolved in a way that serves the public interest.

2. *Role of Bellcore*

a. *Positions of the Parties*

84. Noting that Bellcore is jointly owned by the BOCs, some IXCs argue that it is inappropriate for Bellcore to serve as administrator of the SMS.[171] These IXCs state that the SMS should be administered, instead, by an independent third party or an entity owned or controlled by both IXCs and LECs.[172]

85. MCI and ALC further argue that Bellcore should not play a role in establishing rules for 800 number administration, such as guidelines for the assignment of 800 numbers.[173] MCI and ALC claim that despite an assumption on the part of the BOCs that Bellcore has legal power to establish such guidelines by virtue of its role as administrator of the North American Numbering Plan, this Commission has plenary jurisdiction over such matters and has never authorized Bellcore to perform number assignment functions for 800 service.[174]

86. The BOCs and USTA state that Bellcore, as designer of the SMS and administrator of the North American Numbering Plan, is best qualified to administer the SMS.[175] They claim, further, that Bellcore, with industry input, developed guidelines for the assignment of 800 NXX codes to carriers and has been assigning these codes without complaints about its competency or fairness in administering this function.[176] BOCs argue that the role of the 800 number administrator will diminish, in any case, with the deployment of the data base plan, both because 800 number guidelines have already been developed by Bellcore and because IXCs will be able to search for and reserve numbers directly, without involvement of the SMS administrator.[177]

87. Despite their insistence that Bellcore is well-qualified to administer the SMS, the BOCs state that they will contract with an independent third party to perform this function. They state that they have retained a consulting firm to develop and administer a competitive bidding

process under which this third party will be chosen.[178] BOCs argue that until this contract is awarded, Bellcore should be permitted to administer the SMS.

88. The BOCs oppose suggestions that the 800 number guidelines developed by Bellcore through the OBF are inadequate. They state that these guidelines were developed in an open forum, and that the only party to object (except as to minor wording changes) at the time was MCI.[179] They state that it is unnecessary for this Commission to develop new guidelines, and they question whether we would have jurisdiction to do so without participation of Canadian authorities insofar as the North American Numbering Plan applies both to the United States and Canada.[180]

b. ***Discussion***

89. Although certain IXCs object to a Bellcore role in administering the SMS, it appears that the BOCs and Bellcore have largely responded to IXC concerns. The BOCs state that Bellcore will transfer administration of the SMS to an independent third party and that the BOCs have retained a consulting firm to select the new SMS administrator. This firm has issued a Request for Proposals (RFP) from interested and qualified parties, and it appears that a new administrator will be chosen in the near future.

90. We find unconvincing ALC's objections to the manner in which the BOCs are choosing an SMS administrator. There is no evidence that the consulting firm chosen by the BOCs cannot discharge its responsibilities impartially or that the new SMS administrator will in any way favor the BOCs or disadvantage other carriers. In the event that any party is aggrieved by the actions of the SMS administrator, our complaint process is available to address such grievances. Similarly, we are not persuaded of the need for new 800 number administration guidelines. The guidelines were adopted after inter-industry discussions at the OBF, and although certain parties may object to them, their objections relate principally to the forum in which these guidelines were adopted and to the incorporation of number administration functions in the SMS.[181] Moreover, Bellcore, in conjunction with the OBF, has adopted and implemented rules for the assignment of NXXs, which are even more valuable than individual 800 numbers, and no IXC claims that these rules favor the BOCs or have been administered by Bellcore impartially. If, however, a party has reason to believe that the 800 number administration guidelines are unfair or not in the public interest, it may file a petition or complaint specifying its objection, and we will consider the matter accordingly.[182]

3. ***Information to be Loaded into the SMS***

a. ***Positions of the Parties***

91. BOCs and IXCs also disagree over the type of information IXCs should be required to load into the SMS. In their comments, all of the BOCs except US West state they require three pieces of information from IXCs: (1) the 800 number; (2) the status of the number (*e.g.*, whether it is working, reserved, or disconnected); and (3) a jurisdictional indicator identifying the location at which the 800 number terminates.[183] The first two items, they state, will enable them to identify the subscriber's IXC and determine whether the call should be routed to that IXC. The jurisdictional indicator, they state, will enable them to bill access charges more accurately than do the Percentage of Interstate Use (PIU) reports that IXCs currently provide for 800 service. LECs state that the indicator will also enable them to identify and route their own intraLATA traffic.

92. The jurisdictional indicator sought by the LECs varies, depending on the type of service. For a purely interstate service, the LECs request the terminating NPA. For an interstate/intrastate service provided exclusively by other carriers (*i.e.*, where intraLATA competition is permitted and the subscriber chooses not to use the LEC for intraLATA service), LECs seek the terminating NPA and NXX. LECs state that this information will enable them to distinguish intrastate/intraLATA traffic from intrastate/interLATA traffic in states in which different access rates apply to the two kinds of traffic. Finally, if the service includes intraLATA service provided by the LEC, the LECs seek the POTS number. LECs state that they need this information so that they can identify and route their intraLATA 800 traffic.

93. US Sprint, ALC, and MCI object to this information request, particularly the request for the jurisdictional indicator.[184] They note that in April 1988, the Common Carrier Bureau suspended a Southwestern Bell tariff proposing similar reporting requirements for 800 NXX service on the ground that the accuracy of Southwestern Bell's proposed reporting methodology was unclear.[185] These IXCs argue that jurisdictional indicators present the same problems that Southwestern Bell's tariff presented. They assert, for example, that jurisdictional indicators are not useful if calls are dynamically routed[186] to multiple termination points since it is not possible to predict in advance the terminating location of these calls. They note, further, that jurisdictional indicators cannot be used when 800 numbers are dialed as access codes, since in that instance, the 800 number is used only to route the call to an IXC switch, not the called party. US Sprint states that FONCARD traffic acounts for more than three-fourths of its overall 800 service traffic. US Sprint, ALC, and MCI argue that the current system of PIU reporting thus provides more reliable access code data than would jurisdictional indicators.

94. ALC and MCI argue further that the jurisdictional indicator represents proprietary information that the BOCs could misuse. In particular, they state that the BOCs could use this information to block and capture all intraLATA 800 traffic.[187] ALC also claims that since the jurisdictional indicator identifies subscribers with intraLATA 800 service, the BOCs could use this informatin to identify intraLATA 800 numbers, particularly those that are used most heavily, and target their marketing efforts accordingly.

95. In response to IXC assertions that jurisdictional indicators will be of little use for dynamically routed 800 service, the BOCs recently modified their information requests. Ameritech and NYNEX now state that they will accept PIUs in lieu of jurisdictional indicators as measurement tools, while Bell Atlantic, BellSouth, and Southwestern Bell state that they will permit IXCs to provide PIUs for traffic that is dynamically routed or otherwise not measurable with jurisdictional indicators.[188]

b. *Discussion*

96. We agree with IXCs that argue that the BOCs should continue to allow IXCs to provide PIUs as the jurisdictional basis for assessing access charges for 800 calling. The BOCs have not shown that the jurisdictional indicators they propose would provide more reliable data than PIUs. Indeed, it appears that jurisdictional indicators would provide incorrect data in some situations, such as when an IXC is using dynamic routing for its 800 traffic. We see no reason to complicate matters for IXCs by requiring them to provide jurisdictional indicators in some situations and PIU data in others, as proposed by some BOCs. Although PIUs are a surrogate for actual routing data, the BOCs have not demonstrated that PIUs are inaccurate or otherwise unsatisfactory.

97. We do require IXCs using the data base system to provide the BOCs with the POTS numbers of 800 subscribers that will use a BOC for its intraLATA 800 service, either by choice or because the subscriber requests service in a state that does not permit intraLATA competition.[189] In these situation, the BOCs require this information in order to recognize their own 800 traffic, and we see no legitimate reason why IXCs should withhold it from them.

F. *800 Directory Assistance (800 DA)*

98. The *Supplemental Notice* also sought comment on the manner in which 800 DA should be provided. Noting that AT&T is currently the only source of 800 DA service, that it controls the number (800) 555-1212, and that it provides 800 DA service on an untariffed basis, we sought comment on whether this arrangment was consistent with the public interest, and, if not, what alternative arrangements should be made.[190]

1. *Positions of the Parties*

99. Parties addressing 800 DA issues agree that 800 DA listing opportunities should be made available on a nondiscriminatory basis to all carriers offering 800 service.[191] Beyond that, there is little consensus in the record. Some parties argue that 800 DA must be available from a single, centralized source. [192] Others do not oppose multiple 800 DA listings, so long as each DA provider has access to all listed 800 numbers. [193] Southwestern Bell states that DA service should be available from a centralized source in each region, with different sources potentially serving different regional areas.[194]

100. AT&T argues that we need not address 800 DA issues in this proceeding. [195] It claims that since we issued the *Notice*, it has begun offering arrangements for all carriers to include their customers' 800 numbers in AT&T's DA system. It states that MCI has already listed its 800 numbers and that discussions with other carriers are ongoing. Teleconnect states that it would not oppose the continued provision of 800 DA service by AT&T, subject to appropriate nondiscrimination safeguards, including a requirement that AT&T provide this service to others on the same terms, including costs, on which it provides the service to itself. [196] Teltec takes no position on who should provide 800 DA service, but states that if AT&T retains control over this service, it should be required to provide it on a tariffed basis.[197]

101. MCI states that it is not dissatisfied with AT&T's service, including the security measures that AT&T has implemented to protect the confidentiality of information provided by AT&T's competitors for DA listings. Nevertheless, MCI urges us to initiate a competitive bidding process for 800 DA rights. MCI states that such a process would ensure that the price charged for 800 DA service was reasonably related to the costs of providing it.[198] Several of the BOCs endorse this concept of competitive bidding for 800 DA rights. However, whereas MCI states that BOCs should not be allowed to provide 800 DA, the BOCs state that the bidding process should be open to all qualified parties.[199]

102. US Sprint, ALC, and Microtel state that 800 DA should be provided by a neutral third party, not a BOC or an IXC providing 800 service.[200] Neither Sprint nor Microtel proposes any particular mechanism for choosing a DA provider.[201] ALC suggests that an 800 oversight committee composed of 800 carrier representatives search for and recommend prospective candidates to us and that we ultimately choose the DA provider after seeking public comment on these recommendations.[202] ALC also states that, as a nondiscrimination safeguard, the DA provider should be required to file copies of all contracts and/or tariffs, as well as its procedures for searching, displaying, and storing information.[203]

103. Finally, claiming that none of the 800 DA solutions proposed in the *Supplemental Notice* are entirely satisfactory, Bell Atlantic recommends that we allow AT&T to continue providing 800 DA for now, subject to nondiscrimination and equal access requirements, but refer 800 DA issues to the Carrier Liason Committee for development of a better long-term solution.[204]

2. *Discussion*

104. It appears from the record that at least some of our concerns with regard to the provision of 800 DA service have been addressed through steps taken by AT&T in its provision of this service. AT&T states that it has opened its DA service to all 800 carriers and that it currently provides DA service for several IXCs, including MCI. Moreover, only one IXC, Microtel, alleges that the arrangements offered by AT&T are unsatisfactory. Nevertheless, although no party alleges that AT&T has discriminated in its provision of 800 DA, and AT&T has apparently developed security procedures to protect proprietary information provided by other carriers,[205] we are concerned about the incentives and market power inherent in a situation in which an 800 service carrier provides the only DA service for the industry.[206]

105. Some parties urge us to establish a competitive bidding process for 800 DA rights. While a competitive bidding process might ensure in the short-term that 800 DA is provided on the most favorable terms possible, it would not necessarily address our concerns about the potential for discrimination that is inherent when one carrier provides a monopoly service to its competitors. Other parties state that we should place 800 DA in the hands of a neutral third party. While it is conceivable that at some point in the future we may so conclude, the record does not support such action at this time. As noted, only one IXC finds fault with the terms and conditions on which AT&T currently offers 800 DA. Moreover, since AT&T has 800 DA facilities in place and operational, as well as experience with providing this service, AT&T can presumably offer this service on a reasonably efficient basis. Indeed, the costs that another

entity would incur in establishing and providing this service might well outweigh the benefits to be gained by placing DA in the hands of a neutral third party.

106. Therefore, we conclude that, at least for now, AT&T may continue providing 800 DA service under the number (800) 555-1212. However, because at the present time, this is, for all practical purposes, a monopoly service, we require AT&T to tariff this offering. This means that AT&T must provide 800 DA on a nondiscriminatory basis and, to this end, we require AT&T to include in its tariff a description of its procedures for handling, listing, displaying, and providing DA information to callers. AT&T should file its 800 DA tariff within 45 days of the release of this order. Finally, we encourage parties to continue exploring 800 DA issues in industry fora and to develop alternative solutions that might be superior to existing arrangements.

G. *Miscellaneous Issues*

1. *Application of ONA*

a. *Positions of the Parties*

107. MCI argues that because the underlying components of the data base system architecture can be used to support a variety of enhanced (as well as basic) services, ONA principles apply to these facilities.[207] It asks us to clarify that our ONA policy requires the BOCs to unbundle the underlying components of the data base system so that other "service providers" may use these components for their own services.[208] In reply, US West and PacTel state that MCI misapplies our *Computer III* policies. They state that our ONA principles do not require the BOCs to unbundle their network for other network service providers, such as MCI, to use in providing network services.[209] US West states that we specifically rejected MCI's argument to this effect in *Computer III*. Claiming that MCI fails to identify the components of the data base system to which it seeks access, US West states, further, that it is difficult to understand what MCI has in mind when it contends that it has been denied ONA access.[210]

b. *Discussion*

108. MCI is correct in arguing that ONA principles apply to the BOCs' investment in the data base system, just as they apply to other BOC network facilities. It is also true that BSEs offered by the BOCs are available to any customer for any use. To the extent MCI seeks a clarification of these points, we reiterate them now. However, it appears that MCI argues that *Computer III* requires the BOCs to unbundle their networks at the request of, or to meet the specific needs of, other network service providers, specifically 800 service providers. As US West notes, we rejected this argument by MCI in the *Phase I Reconsideration*.[211] That order stated: "We do not require carriers to develop BSEs that satisfy the needs or desires of all segments of the telecommunications industry. . . . [C]arriers need only provide new BSEs pursuant to requests for their use in enhanced services."[212] Therefore, the claim MCI seems to raise is based on a misinterpretation of *Computer III*. In any event, this is not the appropriate proceeding in which to raise issues as to the adequacy of the unbundling proposed in the BOCs' ONA plans. These and other issues pertaining to the merits of these plans have been and will continue to be addressed in the *Computer III* proceeding.

2. *Regulatory Flexibility Act*

a. *Positions of the Parties*

109. NTCA disagrees with our finding in the *Supplemental Notice* that the Regulatory Flexibility Act[213] does not apply to the rule changes proposed in this proceeding. In particular, it disputes our conclusion that the Regulatory Flexibility Act is inapplicable to small exchange carriers.[214] It also challenges our finding that the data base proposal would not have an adverse impact on small carriers since those carriers would be able to participate in the plan without substantial cost by routing 800 traffic to larger telephone companies. NTCA states that if small carriers were forced to trunk their 800 traffic to another carrier, the small carrier could eventually lose control of its relationship with subscribers and IXC customers.

b. *Discussion*

110. In *MTS and WATS Market Structure*,[215] we held that because of the nature of local exchange and access service, small telephone companies are dominant in their fields of operation and therefore are not small entities as defined by the Regulatory Flexibility Act. NTCA has offered no new arguments or evidence to alter our conclusion. Nevertheless, although the formal procedures of the Regulatory Flexibility Act do not apply to small LECs, we are committed to reducing the regulatory burdens imposed on these companies, whenever we can do so in a manner consistent with our other public interest responsibilities. Accordingly, we have considered the impact of this order on small LECs. We conclude that small LECs would not be adversely affected by this order because we do not require them to participate in the data base plan. Moreover, as we noted in the *Supplemental Notice*, small LECs that wish to participate in this system may do so without incurring substantial costs by routing 800 traffic to larger telephone companies. NTCA does not show that LECs that route 800 traffic to another carrier for screening will lose control of their relationship with their customers. Customer relationships should be unaffected by the manner in which LECs choose to perform 10-digit screening. Moreover, since the issuance of the *Supplemental Notice*, it has become clear that LECs have a wide variety of other options available to them for participating in the data base system. These factors further buttress our conclusion that small LECs will not be adversely impacted by the action taken herein.

IV. ORDERING CLAUSE

111. Accordingly, pursuant to the provisions of Sections 4(i), 4(j), 201-205, 218, 220, 403, and 404 of the Communications Act, 47 U.S.C. §§ 154(i), 154(j), 201-205, 218, 220, 403, and 404, the policies, rules, and requirements set forth herein ARE ADOPTED.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

APPENDIX

List of Parties that Filed Formal Comments

Ad Hoc Telecommunications Users Committee (AHTUC)

Alascom, Inc. (Alascom)

ALC Communications Corp. (ALC)

ALLTEL Corp. (ALLTEL)

American Telephone and Telegraph Co. (AT&T)

Ameritech Operating Companies (Ameritech)

Bell Atlantic Telephone Co. (Bell Atlantic)

BellSouth Corp. (BellSouth)

Cable & Wireless Communications, Inc. (Cable & Wireless)

California Bankers Clearing House Assoc. & VISA U.S.A., Inc. (CBCHA/VISA)

Central Telephone Co. (Centel)

Cincinnati Bell Telephone Co. (Cincinnati Bell)

Citizens Utilities Co.; Pond Branch Telephone Co.; Granite State Telephone Co.; Fort Bend Telephone Co.; Merrimack County Telephone Co.; Elkhart Telephone Co., Inc.; Telephone Electronics Corp.; Taconic Telephone Corp.; & Ronan Telephoe Co. (Citizens Utilities)

Competitive Telecommunications Assoc. (CompTel)

CompuServe, Inc. (CompuServe)

Contel Corp. (Contel)

Direct Marketing Assoc. (DMA)

Florida Public Service Commission (Florida)

GTE Service Corp. (GTE)

International Communications Assoc. (ICA)

Steven V. Jackson

MCI Telecommunications Corp. (MCI)

Michigan Public Service Commission (Michigan)

Microtel, Inc. (Microtel)

Mountain States Telephone and Telegraph Co.; Pacific Northwest Bell Telephone Co.; and Northwestern Bell Telephone Co. (US West)

National Data Corp. (NDC)

National Telephone Cooperative Assoc. (NTCA)

NYNEX Telephone Companies (NYNEX)

The Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)

Pacific Bell and Nevada Bell (PacTel)

People of the State of California and the California Public Utilities Commission (California)

Puerto Rico Telephone Co.

SouthernNet, Inc. (SouthernNet)

Southern New England Telephone Co. (SNET)

Southwestern Bell Telephone Co. (Southwestern Bell)

Sugar Land Companies (Sugar Land)

Teleconnect Co. (Teleconnect)

Telephone Utilities Exchange Carrier Assoc. (TUECA)

Teltec Saving Communications Co. (Teltec)

U.S. Intelco Networks & Independent Telecommunications Network (U.S. Intelco)

US Sprint (US Sprint)

United States Telephone Assoc. (USTA)

United States Transmission Systems (USTS)

United Telephone System Co. (United)

Fred Williamson & Associates

List of Parties that Filed Formal Replies

AHTUC

Aeronautical Radio, Inc. (Aeronautical Radio)

ALC

Ameritech

Armstrong Telephone Co.; Brazoria Telephone Co.; Century Telephone Enterprises, Inc.; and Public Service Telephone Co. (Armstrong)

AT&T

Bell Atlantic

BellSouth

Cable & Wireless

California Bankers Clearing House Assoc.; The Committee of Corporate Telecommunications Users; MasterCard International Incorporated; and VISA U.S.A., Inc. (CBCHA/CCTU)

Cathey, Hutton & Associates (CHA)

Cincinnati Bell

Citizens Utilities

CompuServe

Contel

DMA

GTE

MCI

Microtel

National Assoc. of Regulatory Utility Commissioners (NARUC)

NDC

NTCA

NYNEX

OPASTCO

PacTel

Puerto Rico Telephone Co.

SouthernNet

Southwestern Bell

John Staurulakis, Inc.

Teleconnect

Texas Statewide Telephone Cooperative, Inc. (TSTCI)

U.S. Intelco

US Sprint

USTA

USTS

United

FOOTNOTES

[1] Provision of Access for 800 Service, Notice of Proposed Rule Making, CC Docket No. 86-10, 102 FCC 2d 1387 (1986).

[2] Provision of Access for 800 Service, Supplemental Notice of Proposed Rule Making, 3 FCC Rcd 721 (1988).

[3] Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, *Notice of Proposed Rule Making*, CC Docket No. 89-79, adopted March 30, 1989.

[4] In addition to presenting unique access requirements for LECs, 800 service presents special routing requirements for IXCs, because 800 numbers differ from telephone numbers that are used for local exchange service and ordinary long distance services. (The industry usually describes the local exchange service number as the "plain old telephone service" or "POTS" number.) Therefore, before an 800 call can be carried over the public switched network, the 800 number must be translated into a POTS number or some other routing code.

[5] *See, e.g.*, Steven V. Jackson Comments (alleging that 878 NXX is assigned to a carrier that does not provide service in southern Florida).

[6] The 800 information would be entered into a centralized Service Management System (SMS) and then automatically downloaded to the various regional data bases.

[7] As a technical matter, this system would work as follows: When a caller placed an 800 call, the LEC would route the call to its own, or to another LEC's Service Switching Point (SSP). The SSP would hold the call momentarily while querying, through CCS7 signaling, a regional data base, termed the Service Control Point (SCP). The CCS7 network would link the SSP and SCP through packet switches termed Signal Transfer Points (STPs). The SCP would be able to identify the carrier to which the call should be routed based on a ten-digit reading of the 800 number, and it would relay this information through the CCS7 network back to the SSP, which would then route the call accordingly.

[8] These services are hereinafter described as: "call validation;" "POTS translsation;" "alternate POTS translation;" "multiple carrier routing;" "least cost routing;" and "traffic reporting."

[9] The Communications Act does not require carriers to receive prior authorization for new service offerings. *MCI Communications Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978) (hereinafter *Execunet I*). However, *Execunet I* recognized that this Commission has the authority to make affirmative determinations that the provision of particular services by particular carriers will or will not be in the public interest. *Id.* at 379, 380. In light of the significant ramifications of the data base plan, as well as intense industry interest in issues pertaining to the implementation and administration of this plan, we initiated this Rule Making to ensure that LECs provide an 800 access service that is consistent with the public interest.

[10] *Supplemental Notice*, 3 FCC Rcd at 724, para. 24.

[11] *Id.* at 726, para. 37.

[12] *Id.* at 725-26, paras. 32-37.

[13] A list of parties filing formal comments and reply comments, as well as abbreviations used herein to describe each party is set forth in the Appendix. All comments and reply comments cited herein were filed in response to the *Supplemental Notice*. We accept all late-filed comments and reply comments. In reaching our decision herein, we also considered all informal comments and *ex parte* filings.

[14] *See, e.g.*, NYNEX Comments at 12-15; PacTel Comments at 10-14; U.S. Intelco Comments at 7-8; MCI Comments at 10-14; SouthernNet Comments at 2; AHTUC Comments at 4-5. Some parties, however, state that number portability is less important for some 800 service users (such as transaction validators) than for others. *See* AT&T Comments at 8-9; CompuServe Comments at 3; NDC Reply at 4.

[15] BellSouth Comments at 17-18. US West states that in November 1987, it completed a marketing study of the value of number portability to 800 service subscribers. It states that it asked 199 of these subscribers to rate on a scale of 1 to 10 (with 1 meaning "not at all likely" and 10 meaning "very likely") how likely they would be to change 800 carriers if that change required a change in 800 number. US West states that 63% of the respondents answered with a 1, 2, or 3, indicating that they would be unlikely to change carriers under those circumstances. US West Comments, App. at 45-46.

[16] Even providers of transaction validation services, whose 800 numbers are typically dialed automatically by point-of-sale terminals, argue that it would be expensive and inconvenient for them to change their 800 numbers because it would require that all their terminals in their various merchant locations be reprogrammed. *See* NDC Reply at 22-23.

[17] As noted above, the *Supplemental Notice* suggested that the data base plan would facilitate participation of small IXCs in the 800 market. ALC disputes this assertion, arguing that through networking arrangements, a small IXC can offer a nationwide service by assigning its NXX in regions it does not serve to another IXC and allowing that IXC to carry the traffic originating in such regions. ALC Comments at 23-24. Cable & Wireless and CompTel disagree with ALC's characterization of NXX networking possibilities for small IXCs. Cable & Wireless states that AT&T and MCI have not offered attractive partnership arrangements to regional carriers. CompTel, an association of smaller IXCs, alleges that most BOCs have failed to facilitate networking arrangements among small IXCs for the sharing of NXX traffic. *See* Cable & Wireless Reply at 3; CompTel Comments at 9-10.

[18] US West Comments, App. at 48, n. 62; Bell Atlantic Comments at 10; BellSouth Reply at 47-48.

[19] Bell Atlantic Comments at 7-8; PacTel Comments at 7; Ameritech Comments at 10; CompTel Comments at 12.

[20] CompTel Comments at 12.

[21] Microtel Comments at 5; Teleconnect Comments at 8; CompTel Comments at 3-4. For a further discussion of the vertical features, *see infra* paras. 45-57.

[22] Some parties also claim that the data base plan might increase the incidence of blockage on trunk groups linking BOC end offices and access tandems. Noting that some blockage already occurs, and that AT&T's 800 traffic, which is currently routed directly to AT&T from BOC end offices, would initially be sent, in most cases, to an access tandem under the data base plan, they express concern that the data base plan would increase intraLATA blockage. *See, e.g.*, AHTUC Comments at 12-13; MCI Reply at 21, n. 10. In reply, US West acknowledges that blocking has occurred on BOC trunks linking end offices and access tandems, but claims that this has largely been due to the difficulty of predicting either the market share of OCCs or the effect of divestiture on overall growth of the toll market, as well as the fact that access tandems are new to BOC networks. US West states that the interstate market is now more settled so that forecasting has become easier. All of the BOCs state that they will increase their trunk capacity, as necessary, to accommodate tandem traffic under the data base plan. *See* Bell Atlantic Reply at 7, n. 9; US West Reply at 38; *ex parte* letter from Leon M. Kestenbaum, Vice President, General Regulatory Counsel/Federal, US Sprint, to Donna Searcy, Secretary, FCC, Dec. 1, 1988 (attachments).

[23] Each LEC assumes, for purposes of these projections, that current Part 32 and 36 rules govern the accounting and separations treatment of these costs. For a discussion of the accounting, separations, and access charge issues underlying these cost estimates, see *infra* paras. 58-73.

[24] Projected annual interstate revenue requirements for 800 data base service were as follows: US West $3.0M; Ameritech $1.5M; Bell Atlantic $2.7M; PacTel $3.7M; Southwestern Bell $1*See* US West Comments, App. at 59; Ameritech Comments at 6; Bell Atlantic Comments at 11; PacTel Comments at 40-41; Southwestern Bell Comments at 13; BellSouth Comments, App. I at 14; NYNEX Comments at Exhibit A, p. 1, and Exhibit D, p. 2. In addition, several ITCs that are planning to implement data base systems also filed projected revenue requirements. United projected an interstate revenue requirement of $2.4M and GTE projected an annual interstate revenue requirement of $13.8M during the first year of data base system operation, declining to $6.6M and $5.8M, respectively during years two and three. United Comments, Attachment 3; GTE Comments, Attachment 1-4.

[25] At that time, MCI claimed that the costs of the system would approach $1 billion. *See* Letter from Gerald J. Kovach, Senior Vice President, Regulatory and Public Policy, MCI, to Albert Halprin, Chief, Common Carier Bureau, March 16, 1987. *See also* MCI Motion to Cease Deployment of Interexchange and Information Service Capabilities in BOC 800 Service Database, filed with United States District Court for the District of Columbia, Civil Action No. 82-0192, March 12, 1987, at 7. In response to MCI's claims, the BOCs and GTE filed letters with the Bureau indicating that their combined annual interstate revenue requirement for 800 access service would probably be in the range of $65M to $70M.

MCI expresses skepticism about the substantially reduced cost estimates filed by the BOCs. It claims that the BOCs did not provide sufficient data or supporting documentation to permit reliable analysis of these estimates. In addition, MCI asserts that there are inconsistencies in the data. It also claims that each BOC failed to explain adequately how the BOC will recover CCS7 costs that it excludes from the 800 data base revenue requirement. MCI Reply at 28-39.

[26] We use the term "access time" herein to describe the interval that begins when the caller completes dialing the 800 call and ends when the LEC has delivered the call to the IXC's point of presence. In the *Supplemental Notice*, we used the term "call set-up time" to describe this interval. However, the record indicates that this latter term actually refers to the total time interval between when the caller completes dialing and when he receives a ringing tone or busy signal. Thus, call set-up time includes both access time and the time it takes an IXC to deliver a call to the called party's number.

[27] With CCS7 at end offices, access time under the data base system will be either 1.7 or 1.9 seconds, depending on whether the IXC takes direct (from the end office) or tandem access interconnection. *See, e.g.*, BellSouth Comments, App. I at Figures 4-6; AT&T Comments at 10-13 and App. 1. *See generally* Ameritech Comments at 15, Table 3; NYNEX Comments at 25-29; PacTel Comments at 22-24.

[28] *See ex parte* letter from Leon M. Kestenbaun, Vice President, General Regulatory Counsel/Federal, US Sprint, to Donna Searcy, Secretary, FCC, Dec. 1, 1988, (attached letter from Michael Daly, Account Manager, Bell Atlantic, to John Beall, Manager-Industry Relations, US Sprint, Nov. 21, 1988).

[29] *See Id.* (attached letter from Ellis Hawks, Account Manager, Southern Bell, to William Dorrance, Manager, Industry Relations, US Sprint, Nov. 23, 1988).

[30] *Id.* (attached letters from Eugene Trevino, District Manager, Southwestern Bell, to Jack Weyforth, Director-Industry Relations, US Sprint, Nov. 21, 1988; from Michael Bovalino, Director, NYNEX, to William Dorrance, Manager, Industry Relations, US Sprint Nov. 22, 1988; and from J.F. Biava, PacTel, to Paul Wescott, US Sprint, Pacific Division, Nov. 21, 1988). In the middle range are Ameritech and US West. Ameritech states that by 1992, 170 of its end offices will have CCS7 capabilities, while US West states that by 1995, 70% of its traffic will originate at end offices with CCS7 capability. Ameritech Comments at 16; US West Comments at 23.

[31] GTE Comments at 13.

[32] Cincinnati Bell Reply at 2.

[33] U.S. Intelco Comments at 2, 11. U.S. Intelco is a consortium through which small ITCs provide services that they could not economically provide themselves. U.S. Intelco has established the Independent Telecommunications Network, Inc. (ITN) to develop a CCS7 network and 800 data base system for its members and other small ITCs. According to U.S. Intelco, participating ITCs will be able to use this CCS7 network to provide not only 800 data base service, but other "Intelligent Network" services, as well. *See* U.S. Intelco Comments at 1-6.

[34] Specifically, AT&T proposes a transitional plan in which LECs would be permitted to implement their data base systems on an end-office-by-end-office basis as each office was equipped with CCS7 capabilities. Initially, IXCs would retain their NXXs, and LECs would continue routing 800 calls based on an NXX reading (that would be performed either in a switch or a data base). Once LECs deployed CCS7 in a sufficient number of end offices nationwide, NXX screening would be terminated. *See ex parte* letter from George D. Morlan, Director, AT&T, to Donna R. Searcy, Secretary, FCC, January 19, 1989.

[35] *Id.*

[36] Teltec Comments at 1. USTS, as well, initially favored this approach, but later modified its position to support early implementation of the data base plan. *See ex parte* letter from John A. Ligon, Asst. General Counsel, USTS, to Donna R. Searcy, Secretary, FCC, dated December 14, 1988.

[37] Microtel Comments at 8 and 13-14; Cable & Wireless Comments at 11; CompTel Comments at 8-9. CompTel states that requiring the BOCs to use data base access will ensure that the system works properly during this interim period. CompTel Comments at 9.

[38] *See infra* para. 32.

[39] *See infra* para. 36.

[40] *See ex parte* letter from Leon M. Kestenbaun, Vice President, General Regulatory Counsel/Federal, US Sprint, to Donna R. Searcy, Secretary, Federal Communications Commission, December 1, 1988, and attached materials. This approach is advocated by most LECs as well. *See infra* para. 27.

[41] Teleconnect Reply at 17. *See also ex parte* letter from Shelby Hoffpauir, Vice President - Operations, Mercury Long Distance, to Tom Sugrue, Chief, Policy and Program Planning Division, Common Carrier Bureau, Dec. 7, 1988 (opposing coexistence of NXX and data base systems).

[42] *See* AHTUC Comments at 7-8 and Table 1; NDC Comments at 8-9; CBCHA/VISA Comments at 6-8; DMA Reply at 1; Aeronautical Radio Reply at 11- 12; CompuServe Reply at 6-7; ICA Reply at 3.

[43] DMA Comments at 10.

[44] Aeronautical Radio Reply at 8.

[45] *Id.*

[46] CBCHA/VISA, for example, state that their validation calls average less than 30 seconds in length. CBCHA/VISA Comments at 4. Similarly, CompuServe states that its validation calls average 26-28 seconds. CompuServe Comments at 6. NDC states that an additional 7 seconds of access delay would increase the time required for some of its credit card authorization calls by almost 60%. NDC Comments at 8.

[47] *See* CompuServe Comments at 6.

[48] NDC Reply at 17.

[49] Users are divided as to whether data base access should be provided in the 800 or 400 SAC. AHTUC and ICA favor provision of data base access in the 800 SAC and NXX access in the 400 SAC. AHTUC Comments at 20 and Reply at 29, n. 36; ICA Comments at 5-6. However, DMA, NDC, CBCHA/VISA, and CompuServe recommend that the Commission establish data base service in the 400 SAC. DMA Comments at 7; NDC Comments at 14; CBCHA/VISA Comments at 9; CompuServe Reply at 12. NDC argues that subscribers that wish to use the new access service should have to bear the burden of switching SACs, not those that are satisfied with current arrangements. NDC Reply at 23.

[50] DMA Comments at 8; CBCHA/VISA Comments at 8.

[51] ICA Comments at 4; AHTUC Reply at 25-28, 46; Aeronautical Radio Reply at 12.

[52] CBCHA/CCTU Reply at 3. NDC, citing both cost and delay concerns, also urges us to defer approval of the data base system. NDC Reply at 19.

[53] BellSouth and US West state that call set-up time for interstate Direct Distance Dialing (DDD) calls increased as a result of the MFJ and our equal access requirements, but that callers adapted to these increases. According to BellSouth, the average abandonment time of an interexchange DDD call was 10.4 seconds prior to the divestiture, and 19.1 seconds after the divestiture. BellSouth Comments, App. I at 30. *See also* US West Comments, App. at 22-23.

[54] BellSouth Comments at 9, App. I at 30-31; US West Comments, App. at 22-23; Southwestern Bell Comments at 31; NYNEX Comments at 29; Ameritech Comments at 16; Centel Comments at 4; United Reply at 2-3.

[55] BellSouth, App. I at 29; NYNEX Comments at 29.

[56] NYNEX, for example, states that, in 1987, credit card validation services represented less than .02% (in conversation minutes) of AT&T's total 800 traffic. NYNEX Comments at 30. *See also* Ameritech Reply at 10; Southwestern Bell Reply at 21.

[57] *See* letter from George Morlan, Director, AT&T, to William J. Tricarico, Secretary, FCC, March 26, 1987; and letter from D.J. Culkin, Corporate Vice President, AT&T, to Albert Halprin, Chief, Common Carrier Bureau, April 7, 1987. *See also Supplemental Notice*, 3 FCC Rcd at 726, para. 36.

[58] Some LECs state, however, that because of limitations in the number of unassigned NXXs, it would be impossible to assign up to 3 NXXs to every interested carrier. Therefore, they propose to assign NXXs to IXCs on an as-needed basis only. *See, e.g.*, NYNEX Comments at 32.

[59] US West Comments at App., p. 19-20; PacTel Comments at 25-26; Bell Atlantic Comments at 12-13; *ex parte* letter from Ernest Bush, Director- Federal Regulatory, BellSouth, to Donna Searcy, Secretary, FCC, Jan. 27, 1989 (proposing this alternative on behalf of BellSouth and Southwestern Bell).

[60] *See* TUECA Comments at 6; ConTel Comments at 8. *See also infra* para. 43. Some LECs note that 800 service is only one of many options available to transaction validators and suggest that validators could (and currently do) rely on other arrangements, such as alternative reverse billing arrangements, packet switching networks, or 700 or 900 service. BellSouth Comments at App. 1, p. 9, n. 10; Ameritech Comments at 18; US West Comments at App., pp. 40-41. In addition, several LECs argue that since IXCs do not need Automatic Number Identification (ANI) to bill an 800 call, IXCs could reduce total call set-up time by 1.5 or 2 seconds by not receiving ANI. They suggest, further, that IXCs could reduce call set-up time by having LECs perform POTS translation of the 800 number, thereby eliminating the need for the IXC to query its own data base. *See* BellSouth Comments at App. I, p. 27; US West Comments, App., pp. 26-28; Ameritech Comments at 18; GTE Reply at 12; United Reply at 3. Several users and IXCs criticize these suggestions as unacceptable. *See* NDC Reply at 18; AHTUC Reply at 12-16; MCI Reply at 26-28; AT&T Reply at 6.

[61] LECs do claim that an NXX option would generate certain administrative costs, such as duplicate billing systems and trouble reporting systems. NYNEX Comments at 24; Southwestern Bell Comments at 22; BellSouth Comments at 24.

[62] *See, e.g.*, PacTel Comments at 21; Southwestern Bell Comments at 23-24; Ameritech Comments at 12; Cincinnati Bell Comments at 8; Puerto Rico Telephone Co. Comments at 3; United Comments at 13.

[63] Southwestern Bell also states that if we retain NXX access in some form, we should permit LECs to charge the same rate for NXX and data base access. Southwestern Bell Comments at 21-22.

[64] Ameritech Reply at 15; NYNEX Reply at 28, n.; BellSouth Reply at 16, n. 21.

[65] Southwestern Bell also argues that since transaction validators generally use automatic dialers for 800 number dialing, these users, more so than other 800 users, could accommodate a SAC change. It states: "because the use of the 800 SAC as an indicator of a toll-free call is highly significant where a human caller is involved and totally insignificant where a mechanical autodialer is involved, it would make little sense to introduce a new SAC for the Database System to accommodate the alleged needs of machines." Southwestern Bell Reply at 23.

[66] Ameritech Reply at 15; NYNEX Reply at 28-29; Bell Atlantic Reply at 7.

[67] *See* US Sprint Comments at 7-8; Teleconnect Comments at 15-16; Teltec Comments at 6-8; Microtel Comments at 14; and CompTel Comments at 8-9. MCI and ALC, on the other hand, claim that the BOCs should not be allowed to implement the data base system at all pending correction of delay and other problems. MCI Comments at 43-45; ALC Reply at 7.

[68] Florida Comments at 3.

[69] MCI Comments at 16-17.

[70] MCI Comments at 16-17.

[71] PacTel Reply, Attachment A at 1-4.

[72] BellSouth Reply at 10.

[73] Southwestern Bell Reply at 9. Southwestern Bell states that this cost would have to be incurred for each of its 600 end offices or access tandems (translating into a cost of $120M to $300M). According to US West, over 7000 switches nationwide would have to be modified to implement the MCI proposal. US West Reply at 21.

[74] Southwestern Bell Reply at 9. Southwestern Bell acknowledges that its figures are rough estimates, but argues that it makes far more sense from an administrative standpoint to centralize the information processing centers in data bases that are downloaded by one central system. *See also* PacTel Reply, Attachment A at 5-7; US West Reply at 21.

[75] ALC Comments at 6-10.

[76] ALC Comments at 30-33 and Figure 1.

[77] NYNEX Reply at 25; US West Reply at 23.

[78] Other aspects of the data base plan, such as centralization of the ordering process and the availability of optional features, represent additional benefits.

[79] The data base plan would also increase the cost of 800 access service, although based on the data presented in the record, it appears that this increase would be modest.

[80] *See* CompTel Comments at 12.

[81] *See ex parte* letter from John A. Ligon, Assistant General Counsel, USTS, to Donna R. Searcy, December 14, 1988 (explaining that under NXX access, traffic from equal access end offices is sent to IXCs at a different signaling protocol than traffic from non-converted end offices, and that since USTS switches cannot accept these two different signaling protocols, it must maintain separate trunk groups from each tandem).

[82] LECs should separately tariff data base access so that the charges for this service reflect the cost of providing it. IXCs opting for NXX access should not have to pay higher access charges to receive the same service they receive today.

[83] Alternatively, LECs that wish to implement the data base system in the 400 SAC should file a petition with us specifying their proposal. Any such petition should address how the new toll-free SAC would be administered, including guidelines for the assignment of numbers in the new SAC.

[84] 102 FCC 2d at 1394, para. 18.

[85] 3 FCC Rcd at 725, paras 30-31.

[86] *See, e.g.*, AT&T Comments at 15-17; CompTel Comments at 11-12; OPASTCO Comments at 4; SNET Comments at 3; NYNEX Reply at 14; AHTUC Comments at 11-12; CBCHA/CCTU Reply at 12.

[87] AT&T Comments at 15-17; AHTUC Comments at 11-12; Centel Comments at 2; SNET Comments at 3; BellSouth Comments at 22; PacTel Reply at 22.

[88] BellSouth Comments at 22; AT&T Comments at 15-17.

[89] *See* USTA Comments at 13-17; US West Comments, App. at 48-49; PacTel Comments at 17-21; NYNEX Reply at 14-17; GTE Comments at 8. *See also* Alascom Comments at 2; Sugar Land Comments at 4; ALLTEL Comments at 2; NTCA Reply at 6. LECs citing the USTA study state that ITCs that did not indicate a commitment to the data base plan were not necessarily opposed to it, but were essentially uneducated about it and sought additional information before making a decision.

[90] Contel Comments at 5-10; OPASTCO Reply at 1-4; Citizens Utilities Reply at 1-4; ALLTEL Comments at 1-3; Armstrong Reply at 3-4. Among the options mentioned by ITCs are: (1) development of their own data base system; (2) participation in the US Intelco network; (3) development of their own SSP, which would connect to another LEC's SCP, at least until the ITC implemented its own SCP; (4) the routing of all 800 traffic to another LEC's SSP or to AT&T, if necessary. *See Citizens Utilities Comments at 7-9; U.S. Intelco Comments at 2-3.*

[91] *See* TUECA Comments at 6 (urging 3-year transition period); Contel Comments at 8 (urging that LECs be given until 12/31/90 to participate); Citizens Utilities Comments at 5 (supporting Contel transition plan); Armstrong Reply at 5-6 (urging "reasonable" transition period); TSTCI Reply at 6 (same) CHA Reply at 5 (supporting proposals for transition period). Sugar Land states that we should follow the equal access model and require IXCs that seek data base access to order it from each ITC. Sugar Land Comments at 5.

[92] Though we do not require LECs to implement the data base system, LECs that do implement this system must offer IXCs the option of obtaining NXX access instead. This choice should be made available to IXCs on an NXX-by-NXX basis. Thus, IXCs may elect to receive NXX access for some of their NXXs and data base access for others. Alternatively, IXCs may elect to receive either form of access for all of their NXXs. These rules apply both as to NXXs that are currently assigned and to NXXs that have not yet been assigned. Therefore, the form of access that will be provided on unassigned NXXs will be determined at the time the NXX is assigned by the IXC to which it is assigned.

[93] Clearly the LECs may offer the vertical features at issue here to their own intraLATA 800 customers. The discussion below addresses the extent to which LECs may offer these services to IXCs or IXCs' customers in connection with interstate 800 service.

[94] As noted, these services include call validation; POTS translation; alternate POTS translation; multiple carrier routing; and provision of statistical information on 800 subscribers' traffic. *See supra* para. 10. Although the data base system could be used to provide least cost routing, the BOCs and GTE do not propose to offer this service.

[95] *See, e.g.*, BellSouth Comments, App.I at 29.

[96] Southwestern Bell Comments at 13-14; Bell Atlantic Comments at 6-7; GTE Comments at 5.

[97] United Reply at 10.

[98] PacTel Reply at 15-17; Ameritech Reply at 3-4; US West Reply at 15; Southwestern Bell Reply at 24-25; GTE Reply at 14-16.

[99] US West Reply at 14.

[100] *See, e.g.*, Cable & Wireless Comments at 4-9; Teltec Comments at 2,4; and CompTel Reply at 4. Teleconnect, however, argues that LECs should be limited to performing ten-digit screening with their data base systems. It argues that there is limited demand for the vertical features and that IXCs that seek these features could always obtain them from sources other than the LECs. It also expresses concern that LECs will discriminate in favor of their own optional services through such mechanisms as cross-subsidization. Teleconnect Reply at 2-7. USTS initially conditioned its support of the vertical features on modification of the data base system architecture to conform with ALC's alternative model. *See* USTS Reply at 2-3. However, in a subsequent *ex parte* letter, USTS modifies its view and supports the vertical features within the context of current data base plans. *See ex parte* letter from John A. Ligon, Asst. General Counsel, USTS, to Donna Searcy, Secretary, FCC, Dec. 14, 1988.

[101] Microtel Comments at 5; CompTel Comments at 4. Ameritech, however, claims that even if a small IXC performs basic POTS translation in its own switches, the IXC will not be able to offer alternate POTS translation to its subscribers because this latter capability requires a data base system. Ameritech Comments at 9.

[102] *See* CompTel Comments at 5; Cable & Wireless Comments at 8; Teltec Comments at 4.

[103] ALC would not oppose BOC provision of optional features pursuant to the alternative architecture it proposes. However, it, like AT&T and MCI, argues that the provision of these features under the architecture currently planned would be anticompetitive. ALC Comments at 25, 30-33.

[104] ALC states that virtually every switch on the market today is capable of performing POTS translation. ALC Comments at 24.

[105] MCI Comments at 36.

[106] In arguing that IXCs will compete by using their data base systems to provide better 800 service, ALC assumes that IXCs will be able to implement their own data base systems. However, in its reply, ALC states that AT&T has a patent on the data base architecture and that AT&T has refused to make public the terms on which it will license this patent to IXCs and ITCs that seek to develop their own data base systems prior to the expiration of this patent in 1997. ALC Reply at 32-35. *See also* letter from Roy Morris, Deputy General Counsel, ALC, to Gerald Brock, Chief, Common Carrier Bureau, June 21, 1988. According to ALC, AT&T subsequently announced that it would license this patent in exchange for two percent of the revenues the licensee derives from use of the patent. *See* letter from Roy Morris, Deputy General Counsel, ALC, to Donna Searcy, Secretary, FCC, January 4, 1989.

[107] *See supra* para. 36.

[108] MCI Comments at 32-33.

[109] AT&T Comments, App. 2 at 24.

[110] Some IXCs may wish to purchase these vertical features without purchasing ten-digit screening, which permits number portability. Consistent with our decision to make the data base system optional at this time, LECs that implement the data base system may offer such IXCs vertical features in this manner.

[111] Since LECs do not propose to offer least cost routing with their data base systems, we do not address this service herein.

[112] No party commented on the LECs' proposal that they be permitted to provide statistical information on 800 subscribers' incoming calls. This service, like alternate POTS service, appears to be a nonessential, but useful, service offered by AT&T, MCI, and perhaps other IXCs to their 800 customers. We conclude that it should be treated like the other vertical features, which LECs may offer to IXCs but not directly to 800 subscribers.

[113] While the effect of the AT&T data base patent remains uncertain, it is conceivable that the possibility of an infringement action and/or licensing fees demanded by AT&T will make it less attractive for OCCs to develop and use their own data base systems prior to 1997, when this patent expires. Providing OCCs with the option of purchasing certain data base services from the LECs ensures that OCCs will be able to offer vertical features to their subscribers.

[114] *See, e.g.*, Petitions for Waiver of Various Sections of Part 69 of the Commission's Rules, filed by the New York Telephone Company and the New England Telephone Company, 2 FCC Rcd 61 (1987); GTE Telephone Operating Companies Petition for Waiver of Various Sections of Part 69 of the Commission's Rules and Regulations, Revisions to Tariff F.C.C. 1, 3 FCC Rcd 4674 (1988).

[115] ALC and MCI, in particular, argue that because of the unique calling patterns for 800 traffic, serious network control problems could occur if customers and LECs could unilaterally change the routing of 800 traffic over an IXC's network. *See infra* para. 76.

[116] 3 FCC Rcd at 724, paras. 20-23.

[117] *See, e.g.*, Ameritech Comments at 3; Bell Atlantic Comments at 11; United Comments at 6-7; AHTUC Comments at 24; AT&T Reply at 13; and Cable & Wireless Reply at 4.

[118] The *Supplemental Notice* asked the LECs to provide information on the other services for which the CCS7/data base systems can be used, and the anticipated time frame for their introduction. The LECs indicate that they plan to use their CCS7 systems for a number of services, which they term "Intelligent Network" Services. These include Alternate Billing Services for collect, calling card, and third party calls; Custom Local Area Signaling Services (CLASS); Private Virtual Network service; area-wide Centrex service; Integrated Services Digital Network services (ISDN); augmented 911 service; and others. For the most part, LECs have not yet developed final plans for these services, although some service trials have begun. *See, e.g.*, PacTel Comments at 3-6; BellSouth Comments, App. 1 at 3-6; US West Comments at 9-12; Bell Atlantic Comments, Attachment at 1-4; NYNEX Comments, Attachment A at Exhibit B.

[119] Bell Atlantic states that its CCS7 network will enable it to reduce access time on typical MTS calls by 1.5 seconds. Bell Atlantic Comments at 3, n. 3. GTE states that the faster call set-up will enable it to handle a given traffic volume with 3-5% fewer facilities than required for MF signaling. GTE Comments at 17. GTE also claims that CCS7 will increase the data handling capacity of its network by over 14% by permitting full utilization of its channel capacity for customer information. *Id.*

[120] *See infra* note 207.

[121] US West Reply at 3-4. In addition, LECs state that many IXCs, including MCI, which opposes use of the data base system for 800 access service, have recently requested CCS7 interconnection from the LECs. US West Reply at 20.

[122] *See, e.g.*, Ameritech Comments at 3; Bell Atlantic Comments at 11; PacTel Comments at 34-35; United Comments at 6-7; AHTUC Comments at 24; DMA Reply at 4; AT&T Reply at 13; Cable & Wireless Reply at 4. US Sprint agrees in principle with this approach, but questions whether each BOC properly identifies the 800-specific cost components. US Sprint Reply at 13-15. CompTel also agrees with this approach, while emphasizing that IXCs should not be required through general access charges to pay for purely local services. CompTel Reply at 9. MCI shares CompTel's concern that IXCs will ultimately bear the brunt of core CCS7 costs, even if those costs are not included in the 800 access rate element. MCI Reply at 37, 39.

[123] ALC Reply at 8. *See also* MCI Reply at 38.

[124] ALC states that because each 800 call generates only one packet query to the SCP and one response from the SCP regardless of the duration of the call, any cost allocator based on call duration is inappropriate to the CCS7 network. Instead, says ALC, CCS7 costs should be allocated based on a weighted per query basis. For SCP and SMS costs, ALC would weight each query based on the amount of memory and computation required in the SCP to store and provide the information sought. ALC claims that the vertical features planned by the BOCs require 16 times the memory capacity of basic ten-digit screening. Therefore, in allocating SCP and SMS costs ALC would

apply a factor of 6.3% to queries limited to ten-digit screening. For SS7/STP/SSP costs, ALC would weight each query based on the amount of information carried. It claims since ten-digit screening would require transmittal of three digits only (the carrier identification code), whereas POTS translation requires 13 digits (the code plus the POTS number), an allocation factor of 23% should apply to ten-digit screening. It would also apply another allocation factor based on the amount of information that had to be forwarded to the SCP for processing. *See* ALC Reply at 10-18.

[125] *See* USTA Reply at 12-13.

[126] Bell Atlantic, however, claims that 20% of its SCP hardware cost should be treated as common network costs, not 800-specific costs. Bell Atlantic Comments, Attachment at Table 1.

[127] *See, e.g.*, Southwestern Bell Comments at 19; BellSouth Comments at 8-9 and Figure 1; NYNEX Comments at Exhibits A and D; US West Comments, App. at 57. As noted above, SCP is the term used to describe the regional data bases that provide call handling information in response to network inquiries. The SMS, or Service Mangement System, is the central 800 data base that will be used for 800 number search and reservation functions and 800 order entry. The SMS will download 800 service information to the regional SCPs at regular intervals. STPs are packet switches that transfer messages within the CCS7 network. SSPs are the interfaces between the channels over which originating 800 calls are carried and the CCS7 network. *See supra* para. 8.

[128] In addition, Cincinnati Bell includes an unspecified part of its "initial SSP generic updating expense" in its 800 access revenue requirement. Cincinnati Bell Comments at 4. UTS treats approximately 14% of its SSP costs as 800-specific costs. UTS Comments, Attachment 2.

[129] AT&T Reply at 15.

[130] US Sprint Reply at 14-15.

[131] *See, e.g.*, Ameritech Comments at 5; Southwestern Bell Comments at 16; BellSouth Comments, App. I at 9; GTE Comments at 25-25; USTA Comments at 6; AHTUC Comments at 25; DMA Reply at 5; AT&T Reply at 16. MCI, on the other hand, favors separate accounting treatment of data base system costs. MCI Reply at 41.

[132] AT&T Reply at 16; GTE Comments at 25.

[133] NYNEX Comments, Attachment A at 7; Southwestern Bell Comments, Appendix 1 at Schedule 4; Ameritech Reply, Attachment A at 1. *See* 47 CFR §§ 32.2210-12, 32.6210-12.

[134] *Compare* Bell Atlantic Comments, Attachment at Table 1 (assigning CCS7 data links to Account 2410) *with* Southwestern Bell Comments, Appendix 1 at Schedule 4 (assigning CCS7 data links to Account 2232). *See* 47 CFR §§ 32.2410, 32.2232.

[135] *See* Ameritech Reply, Attachment A at 1 (assigning SMS costs and expense to accounts 2124, 6124, and 6724); BellSouth Comments at Figure 1 (assigning SMS costs to Accounts 6124 and 6724); NYNEX Comments, Attachment A at 7; (assigning SMS costs primarily to Account 6724); US West Comments, Appendix at 69 (assigning SMS costs to Account 6724); Southwestern Bell Comments, Appendix 1 at Schedule 4 (assigning SMS costs to Accounts 2210 and 6210). *See also* 47 CFR §§ 32.2124 (General purpose computers), 32.6124 (General purpose computers expense), and 32.6724 (Information management).

[136] The *Supplemental Notice* advised carriers that these costs should be included in Account 100.2 (Telephone plant under construction) prior to January 1, 1988, and Account 2004 (Telecommunications plant under construction-long term) after that time. We also instructed LECs to account for expenses, prior to January 1, 1988, in Account 139 (Other deferred charges), and thereafter in Account 1439 (Deferred charges). *See* 3 FCC Rcd at 724, n. 34, *citing with approval*, Annual Access Tariff Filings, Memorandum Opinion and Order (released Dec. 24, 1987) at paras. 72-79. *See also* 47 CFR §§ 32.2004, 32.1439.

[137] 47 CFR § 32.2003.

[138] *See, e.g.*, PacTel Comments at 37-38; GTE Comments at 27-28; Southwestern Bell Reply at 26; NYNEX Reply at 35.

[139] *See, e.g.*, NYNEX Comments at 8-9; GTE Comments at 22-23; Centel Comments at 9; USTA Comments at 9; AHTUC Comments at 27-29; AT&T Reply at 16.

[140] BellSouth Comments, App. I at 9; GTE Comments at 22-23; USTA Comments at 9.

[141] In CC Docket Nos. 78-72 and 80-286, a Joint Board considered separations methodologies for special access lines, including WATS access lines, that carry mixed interstate and intrastate traffic. That Joint Board adopted a recommended decision on these matters. *Recommended Decision and Order*, MTS and WATS Market Structure and Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, FCC 89J-1 (released Feb. 7, 1989).

[142] PacTel Reply at 12; NYNEX Reply at 37.

[143] US Sprint Comments at 15-16.

[144] MCI Reply at 41-44.

[145] Teleconnect Comments at 4-5. Teleconnect states that the length of field is "the number of 'slots' reserved for alphanumeric characters in a field of a general record." *Id.* at 4, note 6. Teleconnect does not explain how this allocator would apply to the separations process.

[146] *See, e.g.*, BellSouth Comments, App. I at 11; PacTel Comments at 42-43; Ameritech Comments at 7; GTE Comments at 23; USTA Comments at 10; United Comments at 7-8; Cincinnati Bell Comments at 5; Centel Comments at 8; AHTUC Reply at 38.

[147] Indeed, Bell Atlantic suggests that 800 data base costs are so low that a non-recurring rate element could be used to recover them. Bell Atlantic Comments at 11. Other LECs suggest different pricing formulas. *See, e.g.*, NYNEX Comments at 5-6 (separate rate subelements for basic 800 access service and vertical features); GTE Comments at 19 (proposing one-time installation charge and, perhaps, a monthly maintenance charge for vertical services); Ameritech Comments at 7, n. 8 (claiming that POTS translation should be offered as part of basic 800 access at no additional charge). AHTUC claims that LECs have intentionally avoided consensus on pricing issues in the hopes that specific pricing formulas would not be adopted, thereby making possible strategic pricing of data base access. AHTUC Reply at 39-40. AHTUC urges us to adopt pricing guidelines in this proceeding that preclude LECs from overpricing basic 800 access service. *Id.* MCI also asks us to establish specific Part 69 rules to reduce LEC pricing flexibility. MCI Reply at 45.

[148] BellSouth states that in creating the special access category in Part 69, this Commission recognized that it would be inappropriate to adopt specific elements and cost allocation rules for each special access service, and accordingly provided guidelines, instead, for the tariffing of subelements within this category. BellSouth claims that new technology is blurring the distinction between switched access and special access services and that the special access approach should be used as a model for the access charge treatment of data base services generally, and 800 access service specifically. BellSouth Comments, Appendix I at 12-13.

[149] *See supra* para. 60.

[150] 800 access customers also purchase the standard switched access elements, such as common line, local switching, and transport. The "rates" referred to in the text refer to charges specifically assessed on 800 calls, in addition to the charges assessed on all calls that use interstate switched access services. *See also infra* para. 74.

[151] *See also infra* para. 74.

[152] *See* Revision of the Uniform System of Accounts and Financial Reporting Reaquirements for Telephone Companies, *Second Supplemental Notice of Proposed Rule Making and Order*, 88 FCC 2d 83, 89-90 (1981).

[153] We also clarify that LECs may accumulate capital costs of construction for the data base systems in Account 2003 (Telecommunications plant under construction - Short term) during the year prior to implementation of these systems. Furthermore, we note that in their filings herein, some LECs have purported to classify STP costs in the circuit account (Account 2232) in which signaling equipment is generally recorded. *See, e.g.*, US West Comments, App. at 68; GTE Comments at Attachment 1-2. This classification reflects the current Part 32 Items Lists which show STPs as circuit equipment. However, claiming that the STP is a packet switch that directs signaling messages among facilities, Southwestern Bell has asked the Bureau's Accounting and Audits Division to reclassify STPs in Account 2212, Digital Electronic Switching. *See* Letter from R.M. Schoonmaker, Vice President-Comptroller and Treasurer, Southwestern Bell, to Kenneth P. Moran, Chief, Accounting and Audits Division, FCC, September 30, 1988. This issue is currently pending before the Accounting and Audits Division, and we will not address it here.

[154] Although some parties, such as US Sprint and Cincinnati Bell, argue that the separations treatment of data base system costs may need to be changed because the existing rules would not reflect the relative interstate/intrastate usage of this system, we find their arguments unconvincing for a number of reasons. First, these parties assume that the data base system would be used for all interstate 800 traffic. In light of our requirement that LECs continue to offer NXX access, this assumption will almost certainly be incorrect. Second, those parties ignore the fact that the relative interstate/intrastate usage of the vertical features of the data base system may well be different from usage of the basic access functionalities. Indeed, MCI argues that while the BOCs will make extensive use of the vertical features for their own intrastate 800 service, interstate IXCs will make only limited use of such features, since most major 800 service providers will have their own data bases. MCI concludes, in contrast to US Sprint and Cincinnati Bell, that more data base costs should be allocated to the intrastate jurisdiction than our present rules would provide. For the reasons discussed in the text -- the relatively small amounts of money involved and our desire to keep the separations rules from becoming unduly complex -- we conclude that it is neither necessary nor constructive to attempt to specify special separations rules for the data base system and its various features.

[155] *See supra* note 3.

[156] 3 FCC Rcd at 721, para. 2.

[157] DMA Comments at 12.

[158] Williamson & Associates also states that IXCs "rightfully should interface between their customer and the [LEC] for provisioning/ordering of services." Williamson & Associates Comments at 6.

[159] ALC Comments at 35-39; MCI Comments at 51-55; USTS Comments at 5; Teleconnect Reply at20-22; CompTel REply at 7.

[160] ALC Comments at 35-39; MCI Comments at 51-55. ALC states that the subscriber might not even be aware of the blocking problem or that its traffic was the source. ALC Comments at 39.

[161] ALC Comments at 37-38.

[162] Several BOCs stated that they would address IXC concerns about network management by providing IXCs with advance notice of interLATA service orders or directing subscribers to establish a business relationship with their chosen IXC. *See, e.g.*, BellSouth Reply at 18; Bell Atlantic Comments at 12.

[163] Letter from G.R. Evans, Executive Director, Federal Regulatory Matters, NYNEX, to Donna Searcy, Secretary, FCC, dated Dec. 27, 1988 (hereinafter "NYNEX letter").

[164] *See* Teleconnect Reply at 22; AT&T Reply at 12. *See also* Teltec Comments at 9-10; Microtel Comments at 18-19.

[165] US Sprint Reply at 17; MCI Reply at 48; ALC Reply at 27, n. 55; Comptel Reply at 6-7; Cable & Wireless Reply at 10. ALC states that since the party that creates an SMS record will be the "RespOrg," for that record, SMS access must be made available to IXCs at the time the SMS is initially loaded. ALC Reply at 28.

[166] *See ex parte* letter from Leon M. Kestenbaum, Vice President, General Regulatory Counsel/Federal, US Sprint, to Donna Searcy, Secretary, FCC, dated Dec. 1, 1988. MCI and ALC ask us not to defer resolution of administrative issues to the OBF. They claim that the OBF is controlled by the LECs and Bellcore and that it is thus a biased institution. *See* MCI Reply at 47, 59-63; ALC Reply at 25.

[167] NYNEX letter at 2.

[168] Presumably, then, if a LEC were designated as RespOrg for a nationwide 800 service, the IXC that was chosen to provide a portion of such service would have to inform the LEC of the service order. However, the subscriber could implement subsequent changes to the service record through the LEC directly.

[169] *See* USTS Comments at 5; MCI Comments at 51-55; ALC Comments at 35-39; US Sprint Reply at 18; Comptel Reply at 7.

[170] Bell Atlantic Reply at 12.

[171] ALC Comments at 43-45; MCI Comments at 55-57; US Sprint Comments at 13-14; Microtel Comments at 18; Cable & Wireless Comments at 3-4. ALC elaborates on this claim that Bellcore is not suited to be SMS administrator. It states, *inter alia*, that many Bellcore employees are on tours of assignment from the BOCs; that Bellcore frequently acts as spokesman in public fora for the BOCs and vice versa; and that Bellcore has admitted sharing numbering plan information with the BOCs while refusing to share that same information with other providers. ALC Comments at 44.

[172] ALC proposes that we charter an 800 planning board, consisting of members of the 800 provider industry, to oversee the operation of the SMS. ALC states that all decisions of the board should be subject to our approval and that we should invite public comment before any approval. ALC Comments at 8.

[173] Although it does not object to Bellcore's role in the establishment of guidelines for administration of 800 number assignments, DMA expresses concern over "suggestions that administration of the database plan will involve stringent regulations which (i) sharply limit the ability of a subscriber to reserve a number without a service order and (ii) require a subscriber to release a number if it has not been in active use for a period of time." DMA Comments at 13. DMA states that for many applications, 800 numbers simply cannot be immediately used, and there may be extended periods throughout the life of the number in which its use is dormant. It states, for

example, that it takes months to set up a catalog mailing, and that much of the planning and production is dependent upon the assurance that a particular 800 number will be available when the catalog is released. *Id.* DMA asks us to assure that any system of administration of the data base plan adequately protects the commercial value of numbers in which subscribers have invested. *Id.* at 14.

[174] MCI Comments at 56; ALC Comments at 43.

[175] NYNEX Comments at 36; BellSouth Reply at 19; USTA Comments at 25.

[176] US West Comments, App. at 53; Bell Atlantic Reply at 18.

[177] US West Reply at 42.

[178] In letters sent to each of the BOCs on June 7, 1988, ALC objects to the "failure of the BOCs to consult with the other members of the industry in the search for an independent third party database operator." *See ex parte* letter from Roy Morris, Deputy General Counsel, ALC, to Gerald Brock, Chief, Common Carrier Bureau, June 21, 1988. In reply, NYNEX states that since the BOCs designed, developed and funded the SMS, the selected third party will have to contract with the BOCs for the administration of the SMS. NYNEX states, however, that the chosen party will operate the SMS for the benefit of all users and in accordance with the decision of this Commission in this proceeding. *See ex parte* letter from Kevin Young, Attorney, NYNEX, to H. Walker Feaster, Secretary, FCC, July 20, 1988.

[179] US West Reply at 42, n. 99; PacTel Reply at 32.

[180] US West Reply at 43-44.

[181] *See ex parte* letter from Roy Morris, Deputy General Counsel, ALC, to Donna Searcy, Secretary, FCC, January 26, 1989. The only objection indicated by ALC to the actual number assignment guidelines relates to the use of the term "end users," rather than "assignees." We find this to be an insufficient basis on which to require adoption of completely new guidelines.

[182] We urge the carriers to address DMA's concerns regarding rules governing the reservation and retention of 800 numbers. We recognize that certain guidelines are necessary to prevent users or carriers from reserving or retaining 800 numbers for long periods of time without using them. Such stockpiling of 800 numbers is not in the public interest. On the other hand, the concerns expressed by DMA about overly stringent rules in this area also appear legitimate. We would anticipate that industry guidelines will reasonably accommodate the concerns of DMA and other users, since it is in the interests of LECs and IXCs alike that these rules serve the needs of 800 subscribers. As indicated in the text, however, if DMA, or any other entity, objects to the 800 number administration guidelines adopted by the industry, it may file a complaint with this Commission specifying its grievance.

[183] US West stated that IXCs should have the option of choosing whether to continue providing the Percent Interstate Usage reports used for access billing under the NXX system, or to provide the jurisdictional indicator instead. US West Comments, App. at 52.

[184] ALC states that IXCs should be required to provide only the ten-digit 800 number and the identity of the carrier associated with the number. ALC Comments at 41. MCI states that IXCs should provide the above data plus the subscribed service area for each 800 number. MCI Comments at 48.

[185] *See* Southwestern Bell Telephone Company, Order Designating Issues for Investigation, CC Docket No. 88-180, 3 FCC Rcd 2339 (1988). After the Bureau initiated that investigation, Southwestern Bell amended its tariff so as to make its proposed reports optional. We subsequently terminated the investigation as moot. Southwestern Bell Telephone Company, Memorandum Opinion and Order, CC Docket No. 88-180 (released Feb. 16, 1989).

[186] An example of dynamic routing is "overflow routing," in which calls to a primary terminating location are routed to an alternative location if the primary location has received more than a predetermined number of calls in a given time period.

[187] ALC Reply at 29; MCI Reply at 56.

[188] *See ex parte* letter from Leon M. Kestenbaum, Vice President, General Regulatory Counsel/Federal, US Sprint, to Donna Searcy, Secretary, FCC, December 1, 1988.

[189] IXCs need not provide this information for subscribers that receive NXX access because BOCs would forward these calls to the IXC without performing a POTS translation, in any event.

[190] 3 FCC Rcd at 726-27, paras. 40-44.

[191] *See e.g.*, Ameritech Comments at 23; USTA Comments at 26; DMA Comments at 12; Teleconnect Reply at 24.

[192] PacTel Comments at 33; NYNEX Comments at 37.

[193] US West Comments, App. at 53-4; USTA Comments at 26; GTE Comments at 20.

[194] Southwestern Bell Comments at 36.

[195] AT&T Comments at 15.

[196] Teleconnect Reply at 23-25. Teleconnect states that "it is largely irrelevant" what entity provides 800 DA so long as that entity is not a BOC or Bellcore. *Id.*

[197] Teltec Comments at 10.

[198] MCI Comments at 59.

[199] *Compare* MCI Comments at 58 *with* Southwestern Bell Comments at 36-37. *See also* Puerto Rico Reply at 9-10 (endorsing Southwestern Bell position).

[200] US Sprint Comments at 13-14; Microtel Comments at 16-17. Microtel states that AT&T has expressed a willingness to provide Microtel with 800 DA service, but only at "exorbitant charges." Microtel Comments at 17.

[201] Microtel does, however, address pricing issues. It recommends that 800 service providers share the cost of DA service based on the relative percentage of inquiries made for listings of their respective customers. Microtel Comments at 17.

[202] ALC Comments at 47.

[203] An example of such rules would be rules concerning which 800 number would be listed first for subscribers with more than one 800 number. *See* ALC Comments at 47, n. 51.

[204] Bell Atlantic Comments at 22.

[205] Since those who call 800 DA are not charged for the call, the 800 DA provider must charge the IXC that provides the listing. Therefore, the 800 DA provider must know not only the 800 number of each listed party, but also the IXC that serves each 800 number.

[206] If multiple DA services were offered, market forces could act as a check on AT&T's leverage in the provision of 800 DA service. However, we question the ability of the market to sustain more than one DA service. Because 555-1212 is generally known to be the interexchange DA code, it would appear that whatever party controls this code is virtually assured of a monopoly or at least significant market power in 800 DA service. Of course, other entities are free to offer an alternative DA service, using a different telephone number, if they so choose. Nothing in this order would prohibit such an offering.

[207] ONA is a policy that derives from the *Computer III* proceeding. *See* Amendment of Sections 64.702 of the Commission's Rules and Regulations, *Report and Order*, 104 FCC 2d 958

(1986). Pursuant to our ONA requirements, the BOCs must unbundle the basic components of their network into BSEs so that enhanced service providers can "pick and choose" among discrete network capabilities in designing and providing enhanced services to their customers.

[208] MCI Comments at 59-63. MCI's reference to "service providers" is ambiguous. It is not clear whether MCI is referring to enhanced service providers or network service providers.

[209] US West Reply at 44-47; PacTel Reply at 27.

[210] US West Reply at 45-46.

[211] Amendment of Sections 64.702 of the Commission's Rules and Regulatons (Third Computer Inquiry), 2 FCC Rcd 3035 (1987).

[212] *Id.* at 3050, para. 108.

[213] 5 U.S.C. § 601, *et seq.* (1987).

[214] NTCA Comments at 6-9.

[215] 93 FCC 2d 241, 338-39 (1983).

Before the
Federal Communications Commission
Washington, D.C. 20554

MM Docket No. 87-532

In re Applications of

RENEE MARIE KRAMER	File No. BPCT-870731KV
SKYLIGHT BROADCASTING, INC.	File No. BPCT-870731KX
CARLO B. McDANIEL and MARY S. McDANIEL d/b/a McDANIEL BROADCASTING PARTNERS	File No. BPCT-870731KY
MANATEE TELEVISION, INC.	File No. BPCT-870731LA
BRADENTON BROADCAST TELEVISION COMPANY, LTD.	File No. BPCT-870731LB
JOYNER COMMUNICATIONS LIMITED PARTNERSHIP	File No. BPCT-870731LC
GULF COAST TELECASTERS LIMITED PARTNERSHIP	File No. BPCT-870731LO

For Construction Permit
for a New Television Station
Bradenton, Florida

Appearances

William J. Sill and *John M. Shoreham* on behalf of Renee Marie Kramer; *Christopher C. Smallwood* on behalf of Skylight Broadcasting, Inc.; *Lawrence M. Miller* and *Carol I. Broadbent* on behalf of McDaniel Broadcasting Partners; *David L. Hill* and *Audrey P. Rasmussen* on behalf of Manatee Television, Inc.; *Robert J. Buenzle* and *Henry E. Crawford* on behalf of Bradenton Broadcast Television Company, Ltd.; *William E. Zimsky, Hugh P. Taylor* and *Byron E. Harrison* on behalf of Joyner Communications Limited Partnership; and *Arthur H. Harding* and *Robert J. Keller* on behalf of Gulf Coast Telecasters Limited Partnership; and *Robert A. Zauner* on behalf of the Chief, Mass Media Bureau, Federal Communications Commission.

INITIAL DECISION OF
ADMINISTRATIVE LAW JUDGE
RICHARD L. SIPPEL

Issued: April 12, 1989; Released: April 21, 1989

PRELIMINARY STATEMENT

1. There are seven mutually exclusive applications for a new commercial television station to be constructed at Bradenton, Florida. The applicant parties are: Renee Marie Kramer (Kramer), Skylight Broadcasting, Inc. (Skylight), Carlo B. McDaniel and Mary S. McDaniel d/b/a McDaniel Broadcasting Partners (McDaniel), Manatee Television, Inc. (Manatee), Bradenton Broadcast Television Company, Ltd. (BBTC), Joyner Communications Limited Partnership (Joyner), and Gulf Coast Telecasters Limited Partnership (Gulf Coast). These seven applications, and three others which were dismissed,[1] were designated for hearing by *Hearing Designation Order* DA 87- 1712 (released December 2, 1987), 2 F.C.C. Rcd 7163 (1987), and published at 52 Fed. Reg. 46,659 (December 11, 1987).

2. The following issues set under the Hearing Designation Order remain to be decided:

> 1. To determine, with respect to Gulf Coast Broadcasting, Ltd., Manatee Television, Inc. and Bradenton Broadcasting Television Company, Ltd., whether there is a reasonable possibility that the tower height and location proposed by each would constitute a hazard to air navigation.
>
> 2. To determine which of the proposals would, on a comparative basis, best serve the public interest.
>
> 3. To determine, in light of the evidence adduced pursuant to the foregoing issues, which of the applications should be granted.

Hearing Designation Order, DA 87-1712 (released December 2, 1987).

3. By *Memorandum Opinion and Order*, FCC 88M-1118, released April 14, 1988, the Presiding Judge added financial qualification and related misrepresentation/lack of candor issues against Florida Manatee. As noted above, Florida Manatee's application was dismissed at its own request. Therefore, those issues no longer require resolution. But such issues, insofar as they related to character qualifications, may be revisited at a later date if Florida Manatee applies for a Commission permit. *See Allegan County Broadcasters, Inc.*, 83 F.C.C. 2d 371, 373 (Comm'n 1980).

4. By *Memorandum Opinion and Order*, FCC 88M-1521, released May 20, 1988, the following issues were added by the Presiding Judge against Gulf Coast:

> A. To determine the facts and circumstances surrounding Gulf Coast's failure to report in its application or in a timely amendment under §1.65 that Monroe Berkman, President of Gulf Coast's general partner, was also an officer of Gulf Coast's limited partner, and to determine the effect of such reporting failure on Gulf Coast's basic qualifications to be a Commission licensee.

B. To determine the facts and circumstances surrounding Gulf Coast's certification in its application that its limited partners would have no material involvement in the general partner when Monroe Berkman held office in both the limited and the general partners, and to determine the effect of such certification on Gulf Coast's basic qualifications to be a Commission licensee.

5. A prehearing conference was held on February 9, 1988. Integration and Diversification Statements were required to be filed by December 30, 1987. Direct case hearing exhibits were filed on June 20, 1988 and hearing sessions were held July 11-14, 1987. The Presiding Judge established September 16, 1988 and October 7, 1988 as the deadlines for filing Proposed Findings of Fact and Conclusions of Law and Reply Findings of Fact and Conclusions of Law, respectively. *See Order*, FCC 88M-2883, released September 2, 1988. The parties filed in accordance with that schedule.

6. This decision addresses first those issues which are qualifying and secondly the comparative issues. It is issued in accordance with the Commission's standards at 47 C.F.R. §1.267(b) (initial decision to include findings of fact and conclusions of law as well as reasons or basis therefore). The burden of proof on the issues are with the respective parties. This is an administrative proceeding tried under §5 of the Administrative Procedure Act [5 U.S.C.A. §§551 *et seq.*] and the preponderance of the evidence standard applies. *Steadman* v. *S. E. C.*, 450 U.S. 91, 101 S. Ct. 999, 1007 (1981). Testimony is cited where practicable by the name of the witness followed by the transcript page number, *e.g.*, "Smith, Tr. 0001". References to Proposed Findings of Fact and Conclusions of Law are designated "PFC" and references to Reply Findings and Conclusions are designated "RPFC."

FINDINGS OF FACT

7. Since the seven applications are mutually exclusive, a consolidated factual hearing was conducted on all issues wherein the parties presented evidence and conducted cross-examination. *Ashbacker Radio Corp.* v. *F. C. C.*, 325 U.S. 327, 333 (1945).

QUALIFYING ISSUES

Manatee and BBTC

8. The air hazard issue designated against BBTC was resolved in its favor by *Order*, FCC 88M-906, released March 30, 1988. The Presiding Judge also resolved the air hazard issue designated against Manatee in its favor. *See Order*, FCC 88M-2780, released August 25, 1988. The air hazard issue against former applicant Gulf Coast Broadcasting Limited was mooted by dismissal of that application.

Gulf Coast

9. The special issues added against Gulf Coast relate to allegations that Gulf Coast had certified falsely that limited partners were not involved or to be involved in the general partner. In other words, the adequacy of Gulf Coast's insulation of its limited partner has been challenged. If that issue is resolved against Gulf Coast, it will be disqualified from comparative consideration with the six other applicants. *Louis Adelman*, 28 F.C.C. 432, 434 (Comm'n 1960), *aff'd sub nom Guinan* v. *F. C. C.*, 297 F.2d 782 (D.C. Cir. 1961) (basic qualifications of an applicant should be assessed before comparative analysis).

10. Testimony and documentary proof was presented on the special issue added against Gulf Coast to determine whether Mr. Monroe E. Berkman (Berkman) who was simultaneously president of the general partner and an officer of the limited partner, was exercising control on behalf of the limited partner over the Gulf Coast application and related business matters. Before analyzing the relevant evidence it is necessary to describe Gulf Coast's structure.

11. Gulf Coast is a Delaware limited partnership consisting of two entities: Gulf Coast Telecasters Corporation (Telecasters) which is Gulf Coast's General Partner, and Associated Communications of Florida, Inc. (ACF) which is Gulf Coast's Limited Partner. (Gulf Coast Exh. 1.) Telecasters is 100% owned and controlled by Mr. Berkman. (Berkman, Tr. 621-622.) Berkman conceives of himself and Telecasters as being "one and the same for practical purposes." (*Id.*) Therefore, Berkman considers himself "to be a general partner of Gulf Coast." (Berkman, Tr. 622.) Mr. Berkman has a 20% equity share in the enterprise and ACF holds the remaining 80% as the sole limited partner. (Gulf Coast Exh. 1.)

12. ACF is a subsidiary of Associated Communications Corporation (ACC) which is a communications holding company having over 100 subsidiaries. (Berkman, Tr. 616, 705.) ACF was formed in 1981, for the purpose of obtaining and holding a lease for a transmitter site for radio Station WTYM in Tampa, Florida. Mr. Berkman was the general manager of the station. A separate subsidiary was required to take the lease because the landowner required that the tenant be incorporated in Florida. Mr. Berkman obtained the lease for the land which he selected for WTYM's transmitter site. (Berkman, Tr. 617, 650-51.) Mr. Berkman prepared Gulf Coast's application and signed it on July 31, 1987, the date that it was filed with the Commission. (Berkman, Tr. 626.) ACC sold station WTYM in January 1987, the lease was assigned by ACF, and ACF remained a dormant company until it became a limited partner in Gulf Coast in July, 1987. (Berkman, Tr. 617-618; GCT Exh. 4.)

13. ACF's lease was assigned on January 9, 1987, and Mr. Berkman executed the assignment as ACF's assistant secretary. (Berkman, Tr. 667.) The assignment was formally ratified by ACF's directors on January 29, 1988 (BBTC Cross Exh. 18.) But it was only six months after the assignment through Mr. Berkman that Gulf Coast filed its application here on July 31, 1987, and at that time Mr. Berkman was still ACF's assistant secretary. (Berkman, Tr. 615.)

14. Mr. Berkman stayed on after July 1987 as registered agent for ACF and he has ACF's check signing authority. (Berkman, Tr. 654, 657.) In January 1988, Mr. Berkman resigned as ACF's assistant secretary. But he retained his check signing powers and his responsibilities as registered agent. (Berkman, Tr. 647.) The reason given by Mr. Berkman for retaining his "blanket" position as corporate officer is unclear. But he testified with certainty that when he signed and filed Gulf Coast's application he was a "blanket" vice-president and that he was not consciously aware of the fact that he was a vice-president of ACF. (Berkman, Tr. 649.)

15. The application Form 301 contained a pledge on the part of Mr. Berkman "to resign his position as Vice President of Associated [ACC] - - - as well as any positions he has with any of Associated's [ACC's] subsidiary or affiliate corporations." (GCT Form 301, Exh. 3; Berkman Tr. 618-19.) The limited partnership agreement provides that the limited partner "shall take no part whatever in the control, management, direction or operation of the affairs of the partnership and shall have no power to act for or bind the partnership." (GCT Exh. 4 at pp. 7-8.) Mr. Berkman focused for the first time on the fact that he was an officer of ACF when Gulf Coast prepared and filed its Integration Statement on December 30, 1987, at which time he was advised by counsel to resign the position, which he did. (Berkman, Tr. 688-89.) Prior to that, Mr. Berkman had not consulted corporate records of ACF or of the holding company to determine his specific status and he did not specifically remember that he was a corporate officer of ACF at the time Gulf Coast filed.

16. On December 30, 1987, Mr. Berkman submitted his resignation from ACF in writing and he considered his resignation to have been effective on that date. (Berkman, Tr. 668-69, 698.) Mr. Berkman testified that when he was an officer he had never taken any action on behalf of ACF with respect to Gulf Coast and ACF's only involvement with the application has been the periodic payments of capital calls. (Berkman, Tr. 619-20.) There was no rebuttal evidence offered and the testimony of Mr. Berkman remains unchallenged.

17. It appears from the totality of the evidence that ACF was a mere shell company that served only as a nominal limited partner and that the true role of the "limited partner" or investor entity was the holding company, Associated Communications Corporation. While not alone determinative of that conclusion, it is noted that when Mr. Berkman was asked on cross-examination "what or who is the limited partner" he answered "Associated Communications Corporation or Associated Communications of Florida, Inc." (Berkman, Tr. 622.) The testimony is clear that Mr. Berkman settled on ACF but his first thought was ACC. While having observed the demeanor of the witness his first answer has significance in light of other facts to which he testified. First, it was an officer of ACC, Mr. Keith Hartman, who originated the idea of having ACF serve as limited partner. (Berkman, Tr. 622.) Mr. Berkman was an employee of ACC when Gulf Coast filed its application and remains an ACC employee until the award is made. (Berkman, Tr. 636.) Thus, Mr. Berkman properly did not recognize that contingent promise to leave ACC as a factor that would have prevented ACC's involvement or ACF's involvement (Berkman was an officer of both) in the prosecution of the application. (Berkman, Tr. 637.)

18. But it was not ACF that paid the capital calls. Mr. Berkman testified at trial that capital call requests were given to Mr. Keith Hartman and they were paid by ACC. (Berkman, Tr. 683.) In fact, he admitted that ACF did not even have a checking account and that ACC was paying capital calls as parent company on behalf of ACF. (Berkman, Tr. 684-85.) In his final analysis, Mr. Berkman could offer no business reason for the existence of ACF. (Berkman, Tr. 701-702.) Thus, the key obligations of ACF under the partnership agreement to make capital contributions were not met by ACF, could not have been met by ACF, and were in fact met by ACC under Mr. Hartman's direction. These circumstances show ACF to be the complete alter ego of ACC and nothing more than a shell company which did not have any capability to serve as a limited partner. Through payments needed to prosecute the application, ACC and its officer Mr. Keith Hartman controlled Mr. Berkman who at that time was an employee and shareholder of ACC and whose loyalties ran primarily to ACC and not to the partnership agreement.

19. For reasons stated below in the Conclusions of Law (Paras. 87-88), ACC is found to have acted as controlling person through ACF and through Mr. Berkman in furtherance of Gulf Coast's application and, therefore, Gulf Coast is found to be disqualified as an applicant.

MEDIA DIVERSIFICATION

20. There are no ownership interests in any medium of mass communications attributable to Kramer (Kramer Exh. 2), Skylight (Skylight Exh. 1), Manatee (Manatee Exhs. 1-4), BBTC (BBTC Exh. 4), or Joyner (Joyner Exh. 2).

21. Carlo B. McDaniel and Mary S. McDaniel are partners in McDaniel Broadcasting Partners. Carlo B. McDaniel owns a 49% interest in the partnership. He also owns a 5% interest in the permittee of Station WDSI-TV, Chatanooga, Tennessee for which he has made a timely pledge to divest if the McDaniel partnership receives a grant in this case. Mary S. McDaniel has no ownership interest in any medium of mass communications.

22. Monroe Berkman has no direct ownership interest in any media of mass communication. However, ACC has an interest in two broadcast stations, WSTV and WRKY-FM in Steubenville, Ohio, and an indirect interest in cable television systems operated by Tele-Communications, Inc. (Gulf Coast Appl., Form 301, Ex. 2.) Monroe Berkman has made a timely pledge to resign his position with ACC. (Berkman, Tr. 618-619.) In addition, the Commission has entered the following order which conditions any grant to Gulf Coast as follows:

> Prior to the commencement of operation of the television station authorized herein, permittee shall certify to the Commission that Monroe Berkman has divested himself of all interest in, and connection with, Associated Communications Corporation.

Hearing Designation Order at ¶ 10, 2 F.C.C. Rcd 7163 (DA 87-1712 released December 2, 1987). However, in light of ACC acting as an undisclosed principal, Gulf Coast's diversification pledges are discounted.

23. Based on the findings of fact in paragraphs 20 to 22 above on the absence of attributable mass media ownership, it is found as an ultimate fact that no applicant has any media ownership which is to be considered as a comparative demerit.

COMPARATIVE INTEGRATION PROPOSALS

Renee Marie Kramer

Kramer's Structure

24. Ms. Kramer is a sole proprietor and if Kramer receives the grant, she is proposed to have full control over the management and operation of Channel 66 at Bradenton, Florida.

Kramer's Integration

25. Ms. Kramer is a female who currently resides in Eau Claire, Wisconsin. She plans to move to the Bradenton area in order to effectuate her integration pledge.[2] (Kramer Exh. 1; Kramer Tr. 85-86.)

26. Ms. Kramer proposes to work full-time (a minimum of forty-hours per week) as general manager of the Bradenton station. As general manager, she will supervise all aspects of the station's affairs and she will be solely responsible for the development of station policy. She will have ultimate authority over sales and programming decisions, the hiring and firing of station personnel, and compliance with Commission regulations. Ms. Kramer will terminate her current employment upon grant of her application. (Kramer Exh. 1; Kramer, Tr. 85-6.) Ms. Kramer does not seek qualitative enhancement of her integration pledge by virtue of any civic activities in the Bradenton area. (Kramer Exhs. 1 and 2.)

27. Ms. Kramer learned of the Bradenton allocation through her father who is engaged in the broadcast business. (Kramer, Tr. 76, 88-89.) She retained an engineer who was recommended to her by her father and she made none of the arrangements for an antenna site. (Kramer, Tr. 89, 93.) The engineer recommended the communications counsel and her counsel played a role in EEO compliance under Form 301. (Kramer, Tr. 99, 102-106.) This was Ms. Kramer's first experience with a broadcast application and she has no prior broadcast experience. (Kramer Exhs. 1 and 2.)

Skylight's Structure

28. Skylight is a Florida corporation with the following principals:

Name	Office	Percent Voting Stock
Pauline Zlotolow	President/Director	100
Steve Zlotolow	Vice President/Director	-
Marsha Worthington	Secretary/Director	-
Dr. Ian Zlotolow	Treasurer/Director	-
Robert E. Hensley	Director	-
Allan M. Lichtenstein	Director	-

Skylight is authorized to issue 1,000 shares of stock. Twenty-five shares have been issued to Pauline Zlotolow. (Skylight Exh. 1.). The remaining 975 authorized shares have not been issued.

Skylight's Integration

29. Skylight proposes that on grant of its application, Pauline Zlotolow will be integrated into the day-to-day operations of the station in the capacity of station general manager. Skylight has offered testimony through Ms. Zlotolow to establish that she will work at the station full-time (at least forty hours per week), that she will be responsible for the overall coordination of the station's programming, sales, business and community affairs, and that she will have ultimate responsibility for all station operations. (Skylight Exh. 1.) However, the factual circumstances leading up to Skylight's proposal warrant further consideration in order to test those conclusions.

30. Skylight's Articles of Incorporation were filed with the State of Florida on June 15, 1987. (BBTC Cross-Exh. 1.) Pauline Zlotolow and Steven Zlotolow were listed as initial directors of the corporation. (*Id.*) Steven Zlotolow is Ms. Zlotolow's son. (Zlotolow, Tr. 212-13.) He and Ms. Zlotolow formed the corporation and Steven was made the initial chairman of the board. (Zlotolow, Tr. 210.) He is presently the vice-president and director of the applicant. (Skylight Exh. 1.)

31. Ms. Zlotolow was previously an applicant for Channel 62 in Venice, Florida but that application was dismissed. (Zlotolow, Tr. 121-22.) When incorporating Skylight, Ms. Zlotolow was familiar with the comparative benefits that would accrue to the application if she were the sole stockholder and she stated that the fact that she was the only one who would propose full-time integration was the basis for the decision for her to be the sole stockholder. (Zlotolow, Tr. 150-51.)

32. Twenty-five shares of stock in Skylight were issued to Ms. Zlotolow pursuant to a Promoters Stock Subscription Agreement executed by Ms. Zlotolow on June 30, 1987. (BBTC Cross-Exhs. 3 and 4.) Ms. Zlotolow testified that she was closely involved in the formation of Skylight and that she is fully cognizant of the contents of the corporation's organizational documents. (Zlotolow, Tr. 156, Tr. 158-61.) She also admits that the response to FCC Form 301 which indicates her ownership of 1,000 shares of stock is inconsistent with Skylight's corporate records which indicate the issuance of only 25 shares in her name. (Zlotolow, Tr. 162.) Ms. Zlotolow testified that at the time she signed Skylight's application she believed 1,000 shares of stock belonged to her because that was the amount of stock authorized by the corporation, but she could not explain why she had previously acknowledged in the corporate records and in her Stock Subscription Agreement that she owned only 25 shares of stock. (Zlotolow, Tr. 170-72.)

33. On October 4, 1987, Carole Yellen submitted and Skylight received a letter of intent to purchase 5 shares of stock in Skylight. (BBTC Cross-Exh. 9; Zlotolow, Tr. 177.) Ms. Zlotolow prepared the letter and it was prepared as a form wherein the name of the pledging party and the number of shares pledged could be inserted. (BBTC Cross-Exh. 9.) Ms. Zlotolow testified that although she personally prepared the letter for Carole Yellen's signature, she never intended to effect a future stock transfer. (Zlotolow, Tr. 180-81.) According to Ms. Zlotolow, the pledge was merely a "friendly gesture" on the part of Yellen indicating her willingness to make a loan to the applicant. (Zlotolow, Tr. 179-81.)

34. Skylight received a loan commitment letter from the Barnett Bank of Bradenton, Florida, dated January 21, 1988. (BBTC Cross-Exh. 8.) That commitment is contingent upon Skylight raising a specified amount of capital and upon Ms. Zlotolow retaining control of a majority of the stock in the corporation. (BBTC Cross-Exh. 8.) Even though the loan was expressly contingent upon her retention of a majority control, Ms. Zlotolow testified that the banker had no reason to believe that Skylight would sell its stock in the future. (Zlotolow, Tr.

195.) Ms. Zlotolow testified that a mistake was made and that the letter should read "total control" rather than "majority control." (Zlotolow, Tr. 195.)

35. Ms. Zlotolow received a second commitment letter from The Citizens and Southern National Bank of Florida dated January 15, 1988. That letter approved Ms. Zlotolow's request for a loan "for the purpose of buying stock." (BBTC Cross-Exh. 7.) When asked why she needed additional funds to buy stock if she believed that she owned the entire 1,000 shares of authorized stock, Ms. Zlotolow replied that the banker with whom she was dealing at The Citizen's and Southern National Bank misunderstood her request. (Zlotolow, Tr. 184.) Ms. Zlotolow admitted that she had read the letters upon receipt and had, in fact, herself negotiated for the loans. (Zlotolow, Tr. 184; Tr. 191-94.)

36. There is no subscription agreement by which Ms. Zlotolow pledged to purchase more stock in the corporation. (Tr. 207.) Ms. Zlotolow's children have expressed their willingness to lend money to Skylight in the future. (Tr. 212.) Additionally, her son Steven Zlotolow sits on Skylight's board of directors (Skylight Exh. 1.) and Steven would be hired as a consultant by Skylight. (Zlotolow, Tr. 231.) Steven Zlotolow currently works in the broadcasting field as a producer and operations manager for a public television station in Michigan. (Zlotolow, Tr. 231-32.)

37. In her deposition, Ms. Zlotolow referred to 975 shares of Skylight's stock as having been transferred to her. (BBTC Cross-Exh. 13 pp. 33-37.) But she could not remember when the transfer actually occurred, she did not disclose the circumstances under which the transfer occurred, and there were no corporate documents reflecting the transaction. (*Id.*) According to Ms. Zlotolow's hearing testimony, she only holds 25 shares of stock and no agreement has been produced concerning a transfer to her of the remaining 975 shares. (Zlotolow, Tr. 111, 207.) Now there are no more than 25 shares of Skylight's stock issued and outstanding and the additional 975 shares remain unaccounted for. (Zlotolow, Tr. 112.)

38. On December 25, 1987, Skylight filed an Integration and Diversification Statement reflecting Ms. Zlotolow's ownership of 100% of the voting stock of Skylight. (BBTC Cross-Exh. 6.) The Integration Statement does not make any reference to the stock purchase pledge of Carole Yellen. (*Id.*) Ms. Zlotolow admits that the pledge, if effectuated, would reduce her 100% voting stock interest and she believes that prior to filing the Integration Statement she had requested that Ms. Yellen withdraw the pledge. (Zlotolow, Tr. 177-79.) A letter of withdrawal was provided on January 25, 1988 (BBTC Exh. 9) but that letter of withdrawal neither memorializes a prior action nor references a prior commitment to withdraw the pledge. (*Id.*)

39. Skylight claims enhancement credit based on Ms. Zlotolow's residence in Sarasota for approximately thirteen years and the fact that she currently resides within the station's proposed service area at a point approximately ten miles from Bradenton. (Skylight Exh. 2.) Ms. Zlotolow also claims credit for her female gender. Her local civic involvement includes her participation as a volunteer for United Way of Manatee County (1987-88) and service on the board of directors of the United Way of Sarasota (1978-88). (Skylight, Exh. 2.)

40. Ms. Zlotolow has produced television shows for the Pinellas Association for Retarded Children, St. Petersburg, Florida (1983), the Sarasota/Manatee United Cerebral Palsy Association (1982), the Sarasota United Way (1982-1984), and the Sarasota Board of Education (1987). She has also served as a volunteer for United Way of Manatee County (1987-1988), and on the board of directors of the United Way of Sarasota, Florida (1978-1988).

41. Ms. Zlotolow claims credit for broadcast experience. From 1972 to 1974, she produced community public service programs and a weekly talk show for WDRB-TV, Louisville, Kentucky. She also produced a daily radio show on Station WAVE in Louisville (1974). From 1975 to 1976, she was chief copywriter in the advertising department and hostess of weekly public service shows on WSPB(AM) in Sarasota. (Skylight Exh. 2.)

McDaniel Broadcasting Partners

McDaniel's Structure

42. McDaniel is a general partnership consisting of two general partners: Mary S. McDaniel and Carlo B. McDaniel, husband and wife. (McDaniel Exhs. 1 and 2.) The equity interests in the partnership are divided among the McDaniels as follows: Mary S. McDaniel - 51%; Carlo B. McDaniel - 49%. (*Id.*)

McDaniel's Integration

43. The applicant proposes that Mary McDaniel be integrated into the management of the station as the full-time general manager with a commitment to work forty-hours or more per week. In that capacity, she would maintain overall supervision of the station's management and operations and she would have the ultimate decision-making authority over personnel, editorial policy, EEO, community relations and promotional matters, and general business affairs. (McDaniel Exh. 1.) The partnership agreement specifies broad powers for the managing partner, who is Mary McDaniel, and specifically authorizes her:

> to arrange with the minority partner [Carlo McDaniel] for or to delegate to him the performance of such duties as are appropriate.

(Manatee Cross Exh. 1 at Para. 6(b)(7).) For his part, the agreement requires that Carlo McDaniel:

> shall devote his best efforts to the furtherance of the partnership business.

(Manatee Cross Exh. 1 at Para. 6(c).)

44. Mary McDaniel is a female residing in Tampa, Florida, within the grade A contour of the proposed station. (McDaniel Exh. 1.) She and her husband had agreed orally to apply as partners on July 31, 1987, but there was no written partnership agreement until September 15, 1987, which was prepared at the instance of her communications counsel. (M. McDaniel, Tr. 267.) Mary McDaniel did not participate directly in the selection of the proposed antenna site, or in the development of cost estimates, or in securing a financial commitment. (C. McDaniel, Tr. 313-16.) These responsibilities for site, cost calculations, and financing were undertaken by Carlo McDaniel. (*Id.*)

45. Carlo McDaniel is proposed for integration into management as the full-time station manager. He played an integral role in shaping the partnership's proposal as is indicated by the findings in the preceding paragraph. Carlo McDaniel has lived in Tampa since 1952. He has worked in the broadcast industry as a consultant and he has been employed as a broadcast engineer at TV Station WMOD in Melbourne, Florida. From 1982 to 1984, Mr. McDaniel worked at WMOD in supervising the construction and installation of facilities and operations. He returned to consulting in 1984. (McDaniel Exh. 2 at pp. 2-3.) Before that, from 1955 to 1964, he was a technical staff employee at TV Station WFLA in Tampa when that station was in construction and after it commenced operating. From 1964 to 1976, he was a controlling principal of Industrial Television Systems, a company that specialized in the production of instructional video programs. (*Id.*)

46. Carlo McDaniel's responsibilities at the Bradenton station are to include making decisions with respect to sales, advertising and promotion and he is to supervise the station's operations, engineering and sales staff. But he is to be subject in those areas to the overall supervision of his wife, Mary McDaniel. He is to share responsibility with his wife on editorial and program decisions. (McDaniel Exh. 2 at p.2.)

47. McDaniel seeks credit for service area related civic activities of both partners. Mary McDaniel worked as a volunteer in Tampa for the Heart Association in 1973.[3] But Carlo McDaniel's testimony does not reflect any creditable civic activities.[4]

Manatee Television, Inc.

Manatee's Structure

48. Manatee is a Florida corporation. The officers, directors and their respective shareholdings are as follows:

Name	Officer/Director	% Ownership
Norman B. Hart, Jr.	President/Director Secretary/Treasurer	51.5%
Paul Hoffman	Vice President/Director	41.5%
Elouise Bacon	Vice President/Director	5.0%
Louise Johnson	Vice President/Director	2.0%

One thousand shares are authorized, and 1000 shares have been issued to the above shareholders. (Manatee Exh. 3.)

49. Mr. Hart is proposed as Manatee's chief executive officer. (Manatee Exh. 3, p.2.) Mr. Hoffman is proposed to serve as general manager. (Manatee Exh. 4.) Ms. Bacon is to serve as the station's chief administrative officer. (Manatee Exh. 1, pp. 1-2.) Ms. Johnson proposes to serve as community affairs director. (Manatee Exh. 2.) Each of these principals proposes to work at the station on a full-time basis of 40 hours per week. In order to meet their commitments, Mr. Hart, Mr. Hoffman and Ms. Bacon pledge to resign their employment. Ms. Johnson is retired and she will be available to work at the station. (Manatee Exhs. 1, 2, 3, 4.) These corporate directors shall formulate all policies as a body and Mr. Hoffman will carry them out as the station's general manager. (Manatee, Exh. 4.)

Mr. Hart

50. Mr. Hart has resided at Apollo Beach, Florida since 1986, which is within the Grade A contour. (Manatee Exh. 3.) For the period 1973 to 1986, he resided in St. Petersburg, Florida (*Id.*) which is within the service area. He was a member of the Kiwanis Club from 1968-1979 and he was involved in working with handicapped children in the Tampa Bay area. From 1974-1977, Mr. Hart worked on a local neighborhood crime watch program in St. Petersburg. During the period 1975-1977, Mr. Hart served on a local art advisory committee, as the Mayor of St. Petersburg's appointee on the City's Economic Development Council, on a committee of business and community leaders seeking to promote St. Petersburg, as corporate fund raiser for the Special Olympics, and as a director of Tampa's Big Brothers Chapter. (Manatee Exh. 3.)[5]

Mr. Hoffman

51. Paul H. Hoffman is a vice-president and director. He also holds a 41% shareholder's interest in the venture. Mr. Hoffman has promised to relocate to Bradenton and he is entitled to credit for his move.[6] Mr. Hoffman will serve as full-time general manager and his duties will include the day-to-day operational responsibilities. He also will implement policies on programming, administrative and financial matters, and EEO. (Manatee Exh. 4.)

52. Mr. Hoffman claims credit for prior residency (1968-1975) and civic activities (1969-1983) in the Tampa Bay area. (Manatee Exh. 4.) While the Tampa Bay area is not defined in Manatee's PFC it appears in related contour maps filed with the application to include the areas within the 80 dBu, Grade A, and Grade B contours.[7] The activities claimed are considerable and they include membership with the chamber of commerce, American Cancer Society (local chapter), parental drug awareness program and co-chair of an airport development project. However, no credit will be afforded the commercially related activities of the advertising federation and the marketing arm of a savings and loan association. (Manatee Exh. 4 pp. 2-3.)

53. Mr. Hoffman has been employed as a disc jockey and news announcer at radio station WION in Ionia, Michigan while he was in high school. He performed the same broadcast services at station WCER in Charlotte, Michigan while a college student. Thereafter, in 1961, he hosted his own TV show in WOOD-TV where he also served as news anchor. From 1963 to 1979, he was actively involved in TV broadcasting (news/weather/sports) and in starting up TV stations. In 1968, he became assistant news director and anchor for WTVT-TV at Tampa. In 1975, he became station manager for WYUR-TV at Huntsville, Alabama and in 1977 he became sales manager at WXLT-TV at Sarasota, Florida where he remained until 1979. He also has written, produced and filmed several documentary shows. (Manatee Exh. 4 at pp. 3-4.)

Ms. Bacon

54. Elouise Bacon is a vice-president and a director. She holds a 5% shareholder's interest in the venture. She is a life-long resident of Bradenton where she went to high school and attended the local junior college. She is a black female. (Manatee Exh. 1.)

55. Ms. Bacon is proposed to work full-time as the station's chief administrative officer. She will leave her present employment to work at the station. Her respon-

sibilities will include personnel and EEO matters. In the latter connection, she will be responsible for developing equal employment opportunity policy and procedures and she will need to ensure that the station's practices comply. In conjunction with the station's general manager, she will develop job classifications and she will supervise recruitment and placement. (Manatee Exh. 1.)

56. Ms. Bacon has been concerned with vocational education in Manatee County for 20 years. In 1987, the Manatee County School Board appointed her to the Business Education Advisory Committee to advise the Board on labor needs, market demands and evaluation of student performance and curriculum offerings. She now serves as financial secretary for the Manatee County Choirs Union. Ms. Bacon also is a member of the local NAACP, the American Business Women's Association, (two years as vice president), and the Manatee County Cemetery Committee, a position to which she was appointed by the County Commissioner. (Manatee Exh. 1.)

Ms. Johnson

57. Louise Johnson is a vice-president and a director. She holds a 2% shareholder's interest in the venture. Ms. Johnson is a lifetime resident of the Bradenton area where she taught school for 42 years. Ms. Johnson is a Black female. (Manatee Exh. 2.)

58. Ms. Johnson is proposed to be Manatee's community affairs director. She will be the station's principal liaison with the Bradenton community. She will meet with community leaders to assess their needs and she will be able to carry out that function as she has served on the Manatee County School Board thus giving her a credibility with local politicians and religious leaders. She will work full-time for the station. (Manatee Exh. 2.)

59. Ms. Johnson has had substantial civic involvement with the community. As indicated above, she was on the local school board to which she was appointed in 1976 and thereafter elected to successive four year terms in 1978 and 1982. During her ten years on the board of education she served as its chair and as its vice-chair. In 1987, she organized a continuing education program for adults at the Bethune-Cookman College which meets at the Manatee High School. (Manatee Exh. 2.) From 1976 to 1988, Ms. Johnson was involved with seven local civic activities (local League of Women Voters, Advisory Council for Bradenton Middle School, Church Women of Manatee County, Bradenton Welfare Council, local 4-H Club, Bradenton Branch of the American Association of University Women, and president and treasurer of the Bradenton Women's Club). (*Id.*)

Bradenton Broadcast Television Company, Ltd.

BBTC's Structure

60. BBTC is a limited partnership organized under the laws of Florida. The general partner is Ms. Anita Flenoy Rogers (Rogers). She owns a 22% equity interest. The limited partner is a corporation, MFR, Inc., which owns 78% of the equity. The shareholders of MFR are Thomas H. Minkoff (Minkoff) (48.5% shareholder), Michael Rugers (Rugers) (48.5% shareholder), and Robert Francis (Francis) (3% shareholder). (BBTC Exh. 1.)

BBTC's Integration

61. There exists a partnership agreement which states the duties and responsibilities of Rogers as general partner and the limitations and conditions of insulation of the limited partner MFR, Inc. (BBTC Exh. 6.) Rogers testified that she first learned of the Channel 66 allocation from her husband. (Rogers, Tr. 542.) But her direct testimony offers no explanation of how she got together with the stockholders of the limited partnership and how the venture was put together. Ms. Rogers testified that her husband had learned of the station through a local Commissioner, Ms. Pat Glass, who had known Ms. Rogers when the latter was working in radio. (*Id.*) Ms. Rogers further testified that Ms. Glass arranged for a meeting on May 6, 1987, attended by Ms. Rogers, Mr. Minkoff, Mr. Rugers and Ms. Glass. (Rogers, Tr. 545-46.) Messrs. Minkoff and Rugers outlined the general concept of the limited partnership but no details were given. Ms. Rogers listened and took notes. (Rogers, Tr. 546-47.) Ms. Rogers and her future limited partners left the meeting to consider whether they could get along together in the partnership and Ms. Rogers admitted that she had been "chosen" as the general partner. (Rogers, Tr. 550, 553.)

62. The general recollection of Ms. Rogers, the tenor of her testimony about her assumption based on circumstances to which she was privy, and her explanation and description under oath as to her recollection of those circumstances, support a finding that she and Ms. Clarice Hunt, a Black female newspaper reporter, were being interviewed for the position of general partner. (Rogers, Tr. 556-60.) It appears that Ms. Glass had arranged for the interview, that Ms. Hunt was entering the area when Ms. Rogers was leaving and that Ms. Glass said that "they would be meeting." (Rogers, Tr. 557.) Ms. Rogers "assumed" that Mr. Minkoff and Mr. Rugers were going to meet with Ms. Hunt to discuss the venture because although she was not privy to their conversation, she saw Ms. Hunt enter the room, Ms. Glass pointed her out to Ms. Rogers, and it was clear to Ms. Rogers that "she [Ms. Hunt] was going to meet with them [Minkoff and Rugers]." (Rogers, Tr. 560.)

63. A few days after the first interview, Minkoff called Ms. Rogers and told her that Minkoff and Rugers were "interested in talking to me some more and finding out a little bit more about me." (Rogers, Tr. 561.) Ms. Rogers was interviewed a second time at Minkoff's office in St. Petersburg. (Rogers, Tr. 562-63.) Her husband attended this interview because Minkoff and Rugers "want[ed] my husband to get a full understanding of what my role would be . . . " (Rogers, Tr. 562-63.) During that interview, Minkoff call BBTC's communications counsel, Mr. Robert Buenzle, whom Minkoff described as "somebody who could give more details." (Rogers, Tr. 563.) Ms. Rogers did not know Mr. Buenzle prior to that time but Mr. Rugers stated he knew Mr. Buenzle from "way back." (Rogers, Tr. 563.)

64. Ms. Rogers hired Mr Buenzle without contacting any other attorneys. (Rogers, Tr. 568; 597.) Mr. Buenzle recommended an engineer to Ms. Rogers and she contacted that engineer but he had a conflict. (Rogers, Tr. 598.) Mr. Buenzle then recommended a second engineer, whom Ms. Rogers contacted and hired without first contacting any other engineers. (*Id.*)

65. By the end of the second meeting, Ms. Rogers had submitted her resume, financial statement, credit reference check, and income tax returns for the last three

years to Messrs. Minkoff and Rugers. (Rugers, Tr. 563.) For her part, Ms. Rogers did not receive any documentation from Minkoff, Rugers or Francis until after she was chosen to become their general partner. (Rogers, Tr. 564; 565.)

66. Ms. Rogers first saw a draft of BBTC's limited partnership agreement after she decided to become a general partner and she did not suggest any substantive changes in the agreement. (Rogers, Tr. 568-69, 573.) The executed limited partnership agreement was identical to the first draft Ms. Rogers saw except that certain lines left blank in the draft, specifying names, equity interests, and capital contributions, were filled in. (Rogers, Tr. 569; 570-73; BBTC Exh. 6.) The partnership agreement was executed by Ms. Rogers on July 29, 1987. Thereafter, Minkoff and Rugers decided that Ms. Rogers should receive an extra 2% of equity, without the concomitant responsibility for providing capital contributions on that 2%, because she was a valuable candidate. (Rogers, Tr. 574; BBTC Ex. 6 at 4 and 6.)

67. Ms. Rogers played no role in the site selection. She never sought out any limited partners on her own. (Rogers, Tr. 569.) She never spoke to Ardell Hill, the person listed in BBTC's application as the person giving BBTC reasonable assurance for the transmitter site specified in BBTC's application and she never spoke with Warren Happel, the person listed in BBTC's amendment as the person giving BBTC reasonable assurance to use the transmitter site specified in the amendment. (Rogers, Tr. 575.) Mr. Minkoff met with Mr. Taylor of Barnett Bank to discuss obtaining financing for BBTC and BBTC is relying on that bank for its financing (Rogers, Tr. 600-02.) On the other hand, it was BBTC's counsel, Mr. Buenzle, who arranged for the site selection and he was receiving his instructions from Ms. Rogers. (Rogers, Tr. 575, 600.) Also, although Mr. Taylor of the Barnett Bank wanted to speak with Mr. Minkoff before issuing the letter, Ms. Rogers made the initial contact with the bank and she negotiated the letter. (Rogers, Tr. 565, 601.)

Ms. Rogers' Comparative Credits

68. Ms. Rogers was awarded a BS in Nursing from St. Louis University in 1965. She served in the medical field abroad with the Peace Corps and with Project Hope in Kingston, Jamaica. (BBTC Exh. 2.) In 1977, Ms. Rogers moved to Bradenton and there she became involved in the NAACP Manatee Chapter, the Manatee County Blood Bank, the United Negro Fund of Manatee and Sarasota, the American Cancer Society of Manatee County, the Peace and Justice Committee and the Immigration Assimilation Project of the Sacred Heart Church in Bradenton, and the Manatee County League of Women Voters.[8]

69. Ms. Rogers has been a resident of Bradenton for over the past 10 years. She holds a journalism degree and she has experience as a newspaper reporter in the city of Bradenton, a radio station reporter in the city of Bradenton, and as an owner and publisher of her own newspaper in the city of Bradenton. In 1975, while employed as a nurse, Ms. Rogers began her studies in the field of Journalism and she received her degree in 1977. (BBTC Exh. 2.) She was hired by the *Bradenton Herald* in August 1977 where she was employed as a news reporter for one year. She received her FCC operator's license in 1978 and went to work with Bradenton radio stations WBRD-AM and WDUV-FM where she was employed from 1978 to 1981. (Rogers, Tr. 514, 572; BBTC Exh. 2.) She held positions as a copywriter and general news reporter but except for supervision of a summer intern, she exercised no management responsibility. In 1978, Ms. Rogers also purchased a local bi-monthly newspaper called the *Manatee Informer* at a cost of $500. (Rogers, Tr. 514, 531.) She returned to nursing in 1981 and she also was a reporter for the *Islander* weekly newspaper. (BBTC exh. 2.) She was laid off from the Islander in 1982 and she has not worked full-time since June 1982. (Rogers, Tr. 518, 530-31.) However, Ms. Rogers has been employed in nursing without contract since 1982, and she has worked from 24 to 40 hour work weeks to the present. (BBTC Exh. 2, Rogers, Tr. 516-17.)

Joyner Communications Limited Partnership

Joyner's Structure

70. Joyner is a limited partnership organized under the laws of Florida. The sole general partner and the four limited partners and their respective equity interests are as follows:

Partner	Equity Ownership
Arthenia L. Joyner	20% (Sole General Partner)
Willie E. Gary	20% (Limited Partner)
Clarence P. Wilson	20% (Limited Partner)
Lynn Tepper	20% (Limited Partner)
Wilbert Williams	20% (Limited Partner)

Joyner is proposed to operate under a written partnership agreement dated July 30, 1987 which defines the relationship between Ms. Joyner and the limited partners. (Joyner Exh. 1.) Her duties as full-time general manager will include general responsibility, oversight and supervision of day-to-day operations and she will be responsible for hiring, firing and supervision of all department heads and personnel. She also will formulate policies concerning programming, sales, public affairs, community services, and promotions. (Joyner Exh. 3.) Substantial questions are raised about the sufficiency of the agreement's insulation of limited partners and those terms of the agreement are set forth below.

71. The agreement requires a total capital contribution by the general partner of $5,000 plus a promissory note as an "Investor" (BBTC Cross-Exh. 19) for an additional $25,000. (Joyner, Tr. 837, 867.) All limited partners of Joyner were required to contribute $5,000 and to sign identical investor demand promissory notes. (Joyner, Tr. 867.) The terms of the note reflect that it is negotiable to subsequent legal holders in due course and that default in payment on the note " . . . shall cause the dilution of Maker's partnership interest in [Joyner] pursuant to Article X of the Limited Partnership Agreement . . . " Article X states that in the event of such default, " . . . the Partnership interest of the General Partner may not be reduced or diluted pursuant to the Article X below 20%" but upon default by the general partner, the limited partners would " . . . have the right, but not the obligation, to make the contribution on behalf of the Defaulting Partner" (Article X).

72. Section 4.06 of the agreement provides that:

> the General Partner may, but shall not be obligated to, provide financial and other reports or information concerning the conduct of the Partnership or

the Station to the Limited Partners in such form, and at such time to times, as the General Partner desires or as required hereunder.

and further provides that:

a Limited Partner may provide the General Partner or the Partnership with information on any matters with respect to which the Limited Partner has personal knowledge and which is necessary and helpful to the prosecution of the Partnership's application before the FCC for authority to construct and operate the Station.

(Joyner Exh. 1, Att. A at pp. 12-13.)

Joyner's Integration

73. The first event leading to the filing of the Joyner application was a phone call from Roger Regale, a local attorney, to Ms. Joyner in late June or early July of 1987. (Joyner, Tr. 7.) Ms. Joyner knew Mr. Regale but she had never done business with him before and she had never indicated any prior interest in any radio or television ventures to Mr. Regale and, to the best of her knowledge, Mr. Regale himself had no prior radio or television interests. (Joyner, Tr. 808-812.) Ms. Joyner testified that she never inquired as to why he called her or as to what role she might be expected to play in such an application. (Joyner, Tr. 808-809.) The rational inferences to draw from the testimony is that Mr. Regale called at the request or suggestion of Joyner's communications counsel to determine whether she might be interested in seeking the Bradenton permit. Since Mr. Regale apparently only gave her sketchy information, Ms. Joyner found a need to speak with someone who had more information and that person would be a communications lawyer. In response to that observation or request, Mr. Regale referred her to communications counsel for Joyner, Mr. Hugh Taylor. (Joyner, Tr. 811.) Ms. Joyner called Mr. Taylor immediately and she discussed with him the prospects for a Bradenton TV station. (Joyner, Tr. 815-16.) About ten days later, Ms. Joyner called Mr. Regale and informed him that she had met with Mr. Taylor (it is not clear whether he was retained at that time) and that she was going to pursue the application for Channel 66. (Joyner, Tr. 835.) She told Mr. Regale that he would be required to pay $5,000 and sign a note for an additional $25,000 in Order to be a participant. (Joyner, Tr. 836-37.) Mr. Regale told Ms. Joyner that he had outstanding obligations that prevented him from investing and therefore he would not become involved in the application. (Joyner, Tr. 836.)

74. Before calling Mr. Regale, she also had contacted 7 or more prospective limited partners. (Joyner, Tr. 822.) It was while she was in the process of contacting prospects that she met with Mr. Taylor in Tampa. (Joyner, 816, 825.) Ultimately, she contacted Clarence Wilson, Wilbert Williams, Willie Gary and Ruby B. McZier, to ask them to become limited partners. Those persons and Ms. Joyner have been friends for more than 20 years. After reviewing the limited partnership agreement, a feasibility study and the budget for the proposed station, Wilson, Williams, Gary and McZier decided to become limited partners. (Joyner Exh. 1.) Subsequently, Ms. McZier withdrew and Ms. Lynn Tepper was substituted after she was shown the partnership agreement, feasibility study and budget. (*Id.*)

75. Ms. Joyner has testified that she independently undertook to contact and retain an engineering firm and that later she personally contacted the engineer for Channel 8 at Station WXFL to discuss leasing tower space. (Joyner Exh. 1.) Ms. Joyner also contracted with a firm to provide a feasibility study and budgetary projections and she checked on prices for studio and transmitting equipment. (*Id.*) Ms. Joyner handled the lease and she opened the partnership checking account on which she is the sole signatory. She maintains the partnership books, issues the capital calls, established the public file and she arranged for local publication. (*Id.*)

76. Ms. Joyner will work at the station as the general manager a minimum of forty hours per week. (Joyner Exh. 3.) She received a BA degree in Political Science from Florida A&M University in 1964 and a Juris Doctor degree from the same university in 1968. She is a sole practitioner in Tampa specializing in probate. She represents that if Joyner is awarded the grant she will retire from the practice of law in order to work full-time at the station. (Joyner Exh. 3.)

77. Ms. Joyner is a Black female. She represents that she has lived within Joyner's proposed Grade B contour since 1949. She gave her address while testifying as 7868 Niagara, Tampa, Florida. (Joyner, Tr. 714, 772.) A cursory observation of Joyner's contour map shows that Tampa as within the Grade B contour. (Joyner Form 301 Application at Exh. VC.) She will move to Bradenton if Joyner wins. (Joyner Exh. 3.) Ms. Joyner has no broadcast experience.

78. In Tampa, Ms. Joyner has been engaged in a substantial number of civic projects including fund raiser for a political campaign (Tampa Coordinator 1988); delegate from a Tampa district to a national political convention (1988); member of a local Tampa bar association; member of Tampa based steering committee for a national candidate (1984); volunteer for Lutheran Ministries projects for the homeless in Tampa (1984-); Boy Scout guardian for the Tampa Chapter (1987); member Tampa Bay Area Chapter of the National Conference of Christians and Jews (1987); member of board of directors of University Community Hospital, a non-profit hospital in Tampa (1984-); member, broad of directors, Bay Community Players, Inc. which stages Tampa inner-city productions (1986-); member Tampa Chapter of National Council of Negro Women (1985-); member, board of directors, League of Women Voters, Tampa (1985-88); member and trustee of Allen Temple A.M.E. Church in Tampa (1979-); member, Tampa Chapter NAACP (1966-); member, board of directors, Tampa YWCA (1967-77); member, board of directors, Travelers Aid Society, Tampa Chapter (1980-); member, board of directors, Tampa Urban League (1975); member, board of directors, Day Nursing at Tampa (1978-86); member, board of directors (1977-86) and president (1983-84), Bay Area Legal Services of Tampa. (Joyner Exh. 3.)[9]

Witness Credibility

79. Matters have been raised by BBTC which require separate credibility findings concerning Ms. Joyner's testimony. *See* BBTC's PFC at 74-81 and Joyner's RFC at 25-35. BBTC attacks Joyner's credibility with respect to her alleged commitment to terminate her law practice in order to manage the station. BBTC notes that when Joyner filed and exchanged an integration statement on December 30, 1987, there was no explanation made of

how Ms. Joyner would wind up her affairs. Later, when asked at a deposition whether she had said anything to any client about her commitment, she answered "no." Later, when written case exhibits were exchanged, Joyner had a plan to notify clients after the award is made and provide them with a list of alternate attorneys to select. (Joyner Exh. 3.) BBTC criticizes that disclosure as being "too little" and "too late." BBTC PFC at 76.

80. BBTC also accuses Ms. Joyner of having knowingly misrepresented the fact of a plan in Exhibit 2 for leaving her practice while knowing, or being held to know, that she had made a categorical denial of any such plan in her deposition. *See* BBTC PFC at 76-77. BBTC also accuses Ms. Joyner of vacillating in her testimony (four pages of vacillating and inconsistent testimony) citing Tr. 774-78. I have reviewed that testimony. It reflects that Ms. Joyner has limited her practice to "probate and guardianship" and that she has approximately 60 clients. She answered "yes" to the question of whether she discussed with clients her possible resignation and she specified one particular client and indicated a second when asked. Then she was asked directly about a third and she referred to Mr. Wilson who is a limited partner. Ms. Joyner then admitted that she had not disclosed her plans to the bulk of her clients. Except for Mr. Wilson, who was privy to her plans by virtue of his status as her partner, the other two clients were told after her deposition. Then counsel for BBTC left that line of questioning about specific client knowledge and returned to questions about the nature of Ms. Joyner's practice. On that point, Ms. Joyner's testimony was clear and straightforward. (Tr. 778.) An independent review of the testimony relied on by BBTC together with the opportunity to observe the witness' demeanor while testifying, requires a finding that Ms. Joyner did not mislead and she was not less than candid. The contention by BBTC that Ms. Joyner also was less than candid in her testimony about Mr. Regale's race, or in her estimate of the number of people she had contacted over a ten day period for limited partner prospects, or in the apparent unclarity over national *vis a vis* local organizations contacted in connection with Joyner's EEO disclosure, are rejected. *See* BBTC PFC 77-78. While there was a lack of specificity about a plan to advise clients to seek other counsel, that is a bridge that a lawyer in sole practice would naturally be reluctant to cross until the condition had occurred, *i.e.*, the award of the permit. Certainly, Ms. Joyner, an experienced practitioner, is presumed to be aware of her obligations under the canons of ethics to arrange for a smooth transition of her clients' cases to new counsel. *See, e.g., Code of Professional Responsibility*, DR 2-110 (counsel withdrawal from employment). That process could be done over a period of time, particularly since her practice was primarily "office" oriented as opposed to litigation where matters generally move at a faster pace.[10] Also, it may not be wise to needlessly upset clients who are serving as guardians or who are the subjects of guardianships, about a change which is not imminent and which is contingent. In short, the timing and the manner of notifying her clients are best left to Ms. Joyner. There will be no adverse findings made with respect to the candor of Joyner's testimony.

Gulf Coast Telecasters Limited Partnership

81. For reasons discussed below, Gulf Coast is found to be basically unqualified because it did not secure adequate insulation of its limited partner Telecasters, for a failure to disclose ACC as a real party-in-interest, and for a failure to effect its ownership proposal. However, there are alternative comparative findings made on the contingency that a reviewing authority may disagree.

Gulf Coast's Structure

82. Paragraphs 11 through 17 above are incorporated herein by reference as findings of fact relevant to the standard comparative issue. Gulf Coast is seeking a 100% integration credit based on Mr. Berkman's pledge to work full-time as the station's general manager. (Gulf Coast Exh. 2.) He is prepared to leave his present employment and to terminate or reduce all other activities in order to work full-time at the station. (Berkman, Tr. 619.) No other Gulf Coast equity holder will be involved in the day-to-day management or operation of the station. (Gulf Coast Exh. 2.)

83. Mr. Berkman has resided in the Bradenton area for the past thirteen years. He resides at 4139 Saltwater Boulevard, Tampa, Florida, where he has lived since August 1985. Each of his residences from June 1975 to the present was located within Gulf Coast's proposed City Grade contour. (GCT Exh. 2.) Mr. Berkman has been actively involved in civic affairs of the Tampa community. He has been a member of the Tampa Chamber of Commerce since 1975, serving on the Committee of 100 (1981-1987), the Downtown Development Task Force (1981-1983), and the Commercial Development Task Force (1981-1987). He was a member of the Ybor City Chamber of Commerce (in Tampa) from 1975 to 1987, serving as director from 1981 to 1982. He is also a past member of the Tampa Latin Chamber of Commerce (1979-1987) and Community Concerts of Tampa (1981-1984).[11] (Gulf Coast Exh. 2.)

84. Mr. Berkman has established twenty years of broadcast experience as manager at Tampa's Station WTYM-AM (1975-87); as manager at Philadelphia's Station WRCP-AM/FM; as manager at Chatanooga's Station WRCB-TV (1966); as manager at Buffalo's Station WWOL-AM/FM (1965-66); as assistant director at Steubenville's Station WSTV-TV (1964-65); and as announcer for Pittsburg's Station WPIT-AM/FM (1963-64).

CONCLUSIONS OF LAW

85. Section 307(b) of the Communications Act of 1934, as amended, (the Act) requires the "fair, efficient and equitable distribution" of broadcast service. Therefore, an assessment of the evidence must be made under the applicable Commission standards in determining which applicants meet the statutory standard. *See* Policy *Statement On Comparative Broadcast Hearings*, (Policy Statement), 1 F.C.C. 2d 393 (1965).

86. The primary concerns under the Act are: (1) maximum diffusion of control of the media of mass communications or diversification and (2) best practicable service to the public. *West Michigan Broadcasting Co.* v. *F. C. C.*, 735 F.2d 601, 603-607 (D.C. Cir. 1984) (process of comparative evaluation). Thus, comparative credit will be awarded to applicants which are without other media interests. The "best practicable service" standard includes the integration of ownership into management which may be enhanced by local residence, civic activities, broadcast experience and, if applicable, minority and female gender preferences. However, before conducting the comparative analysis, a determination of the basic qualifications of

each party first must be made. *Louis Adelman*, 28 F.C.C. 432 (1960), *recon. denied*, 29 F.C.C. 1223 (1960), *aff'd sub nom Guinan et al. v. F. C. C.*, 297 F.2d 782 (D.C. Cir. 1961).

BASIC QUALIFICATIONS

Air Hazard Issues

87. It is held as a matter of law that each of the three applicants has met the issue designated to determine whether the tower height and the location which each has proposed would constitute a hazard to air navigation. *See Hearing Designation Order, supra* at Para. 8 (Presiding Judge to determine with respect to all applicants whether there is a reasonable possibility that the proposed tower height and location would constitute a hazard to air navigation). *See also* Findings at Para. 8, *supra*. Factual determinations are made by the FAA that no hazard to air navigation will occur at the designated sites. It is well established that FAA determinations of no air hazard preclude the need for any further inquiry and, in the absence of any substantial evidence to the contrary, such determinations are conclusive as a matter of law. *Southern Capital Television, Inc.*, 47 F.C.C. 2d 197 (1974). *See also Adirondack Television Corp.*, 5 F.C.C. 2d 172, 174 (Review Bd 1966).

Gulf Coast's Failure to Report and Failure to Identify and Insulate Limited Partner

88. Gulf Coast has asked the Commission to accept a proposal that includes ACF as a limited partner when the facts establish that Mr. Berkman, the controlling shareholder of the general partner Telecaster, was at all time leading up to and even after the filing of the Gulf Coast application an officer of ACF and Telecasters. That fact was not timely reported in accordance with the Commission's reporting requirements. 47 C.F.R. §1.65 (an application must be substantially accurate and complete). When the application was filed on July 31, 1987, Mr. Berkman was ACF's assistant secretary. He remained in that capacity until January 1988, when his resignation was reported to the Commission under an amendment in accordance with §1.65. *See Order*, FCC 88M-348, released February 10, 1988 (Presiding Judge accepting Gulf Coast's amendment). Mr. Berkman's activities as ACF's vice-president and assistant secretary were not insubstantial. ACF held the lease to station WTYM where Mr. Berkman was station manager. The lease was assigned by ACF in January 1987, and although ACF had no more business interests, Mr. Berkman remained its assistant secretary. In fact, because of a policy of "blanket" officer positions in the ACC affiliated companies, Mr. Berkman was not only vice-president and assistant secretary of ACF; he also held those positions in the parent company ACC. The evidence conclusively establishes that ACC played the actual role of limited partner with ACF merely serving as a shell company front. For ACF had no bank account and the capital payments were made by ACC. Also, Mr. Berkman coordinated the structure of Gulf Coast and ACF's role as limited partner with Mr. Hartman at times when both were officers of ACC. Mr. Hartman continued to control the purse strings in capital calls even after Gulf Coast's application was filed. The role of ACC was a material fact that Gulf Coast knowingly failed to disclose. Also, there was a motive to avoid disclosing ACC's role. ACC has substantial media interests which would be attributable to Gulf Coast if ACC were shown to control the application. While the evidence in the record may not establish control there are sufficient indicia of control in light of the Hartman- Berkman co-employee relationship to establish a motive for non-disclosure. *See Merrimack Valley Broadcasting, Inc.*, 57 Radio Reg. 2d (P&F) 713 n. 9 (Comm'n 1984) (§1.65 non-reporting violation found where unreported interest was of decisional significance and there was an intent to control or deceive). It is established that Gulf Coast had a duty to timely and accurately report Mr. Berkman's officership in ACF and in ACC and ACC's role as the paying entity under Mr. Hartman's direction. *See Wadeco, Inc. v. F. C. C.*, 628 F.2d 122 (D.C. Cir. 1980). Mr. Berkman's holding of officer positions in both the general partner and the limited partner ACF and ACF's controlling parent company ACC also violated the Commission's attribution rules on limited partnership insulation from management of a broadcast applicant's general partner. *See Ownership Attribution*, 58 Radio Reg. 2d (P&F) 604, 618-19 and n. 61 (Comm'n 1985).

89. Finally, the failure to disclose timely the role of ACF through Mr. Berkman and the role of ACC and Mr. Hartman requires the rejection of Gulf Coast's integration proposal. *Washoe Shoshone Broadcasting*, 3 F.C.C. Rcd 3948, 3954 (Review Bd 1988) (no integration credit awarded where partnership agreement is violated that prohibits limited partners from involvement in day-to-day affairs). Here, Article 6 of the Gulf Coast partnership agreement bars any involvement in the affairs of Gulf Coast by ACF. (Gulf Coast Exh. 4 at 7-8.) Mr. Berkman's simultaneous holding of officerships in Telecasters and ACF and ACC are violations of the agreement which preclude integration credit. *Compare Cotton Broadcasting Company*, 4 F.C.C. Rcd _____, Comm'n Slip Op. FCC 89-49, Paras. 21-22, released February 23, 1989. Furthermore, the partnership agreement was violated in that ACF failed to make its payments and there is no provision for substituting ACC or any other person or entity. (Gulf Coast Exh. 4 at 1.) For these reasons, Gulf Coast is not qualified as an applicant. It's application will only be considered comparatively on a contingent basis.

COMPARATIVE CONCLUSIONS

Diversification

90. Maximum diffusion of control of the media of mass communications is a factor of primary significance. Commission *Policy Statement*, 1 F.C.C. 2d 393, 394 (1965). The Review Board has set the following standard to be used in assessing the comparative weight to be accorded to media interests:

> [T]he appropriate weight to be given to an applicant's other media interests is directly related to the type of other media, size of ownership interest, proximity of other media in terms of area covered, size of audience, number of facilities, etc., significance in terms of regional or national coverage, and significance with respect to other media and their respective localities.

TRC Communications, Inc., 59 Radio Reg. 2d (P&F) 92, 95 (Review Bd 1985).

91. Six of the seven applicants receive full credit for establishing 100% diversification either by virtue of absolute non-ownership or by timely promises of divestiture: Kramer, Skylight, McDaniel, Manatee, BBTC and Joyner. Gulf Coast receives a diversification demerit arising out of the collapse of its integration proposal and the resulting attribution to the media ownership of ACC: Station WSTV and Station WRKY-FM at Steubenville, Ohio. Alternatively, if Gulf Coast's integration proposal is upheld on appeal then Gulf Coast also would receive a full diversification credit under Mr. Berkman's resignation from ACC.

Integration

Kramer

92. Ms. Kramer's proposal as sole proprietor with total control over the station's management and operations is established. In reaching this conclusion, consideration was given to the facts that Ms. Kramer has no prior broadcast experience and that she first learned of the Bradenton allocation from her father. Also considered were the facts that her father recommended the engineer, the engineer recommended her attorney and her attorney assisted in formulating an EEO program. None of these circumstances alone or in their totality establish control, or participation in control, or influence over the Kramer application. *Compare Victory Media, Inc.*, 3 F.C.C. Rcd 2073, 2074 (Comm'n 1988) (Commission will not entertain a claim that a proposal is a sham in the absence of extrinsic evidence of outside influence or control).

93. Ms. Kramer neither claims nor receives any credit for broadcast experience, nor for actual local residency in the community or in the service area, nor for civic activities in the community or service area. She has pledged to move to Bradenton if she receives the permit and for that she receives a slight credit. Ms. Kramer also receives a substantial gender preference.

Skylight

94. The crediting of Skylight's proposal hinges on the acceptance of Ms. Zlotolow receiving full integration credit. Skylight has represented that she is the 100% voting shareholder of the corporate applicant. That conclusion is unacceptable since she is owner of record of only 25 shares. This is not a situation where some corporate technicalities were simply left unattended. *Compare Victory Media, Inc., supra* at 2074 (lack of bylaws held not critical as to establishing non-voting shareholder interests which are well established). Ms. Zlotolow was to be in full command at the filing of the application which represented in Form 301 disclosure that she held 1,000 shares which were all of the shares that were authorized to be issued. But she has never been in full command with only 25 shares. At one time five shares were to be issued to Ms. Carole Yellen in order to raise capital. But Ms. Zlotolow related that the issuance of those shares was never really intended notwithstanding the acknowledged existence of a letter of intent in favor of Ms. Yellen that Ms. Zlotolow had drafted. It is not accepted as credible that the letter was only a "friendly gesture" on Yellen's part to indicate her willingness to make a loan. The bank was concerned that voting stock would be sold to raise capital and therefore insisted on Ms. Zlotolow retaining control. While the bank's concern is relevant to a finding that control in Ms. Zlotolow has not been established, the bank apparently was not aware of the non-issuance of 975 shares.

95. In a post-application second bank letter, it appeared that money would be loaned to Ms. Zlotolow so that she could purchase additional shares, thus even further demonstrating that she knew that she never had control stock when she signed and filed the application. There does not exist a subscription agreement or other corporate record or minute that ascribes the 975 shares to Ms. Zlotolow.

96. Control of the corporation has not been shown to rest with Ms. Zlotolow. But substantial influence is found to have been placed with her son, Steven Zlotolow. Steven was given a seat on Skylight's board of directors and when a permit was issued he would be hired as a consultant. Steven is an experienced broadcaster. While the evidence on Steven's involvement in Skylight's application is not conclusive, as a director and future consultant he shares influence with his mother who is only a 25% shareholder. The failure of Ms. Zlotolow to control the issuance to her of 100% of the voting stock plus her son's positions as officer, director and consultant to-be, are substantial evidence of Skylight's inability to demonstrate a reasonable assurance for carrying out its integration proposal. *Bradley, Hand and Triplet*, 89 F.C.C. 2d 657, 662 (Review Bd 1982). Inchoate ownership arrangements do not provide requisite reasonable assurance until they are finalized. *Houston Family TV, Ltd.*, 101 F.C.C. F.2d 661, 668 (Review Bd 1985). Under these facts it is found that Skylight's proposal has not been finalized and therefore Skylight has failed to prove its reasonable assurance by a preponderance of the evidence.

97. There is an additional related ground for rejecting Skylight's proposal. The parties were required to exchange definitive integration proposals in the form of written statements by December 30, 1988. *See* Presiding Judge's *Order Prior to Prehearing*, FCC 87M-3232, released December 10, 1987. On the date of Skylight's statement, Ms. Zlotolow had only 25 shares of voting stock issued to her, she had no stock purchase agreement for any additional shares, no corporate minute or other document existed to evidence any interest on her part in receiving additional shares of stock, and the Yellen pledge to purchase 5 shares was still outstanding. The Commission has held that "applicants are not entitled to participation credit for proposals that are uncertain and indefinite on the date the proposals are required to be set forth." *Northland Communications*, 100 F.C.C. 2d 914, 917 (Review Bd 1985), *aff'd* 60 Radio Reg. 2d (P&F) 776, 777 n. 3 (Comm'n 1986) (Presiding Judge may set date for complete integration proposals). Here the evidence establishes that Skylight's proposal was uncertain and indefinite on the date of its integration statement and it inaccurately reported the extent of Ms. Zlotolow's holdings. Therefore, credit for integration would be disallowed. *Compare, Warren Price Communications, et al.*, 4 F.C.C. Rcd, Comm'n Slip Op. FCC 89-58, released February 27, 1989 (Presiding Judge may set dates for exchange of complete integration proposals).

98. As contingent findings, the evidence establishes that if Skylight's proposal were accepted the applicant would qualify for a gender preference. Skylight would also receive moderate enhancement credit for Ms. Zlotolow's residence of 13 years within the area of service and for her related moderate civic involvement. She would also

receive slight credit for some broadcast experience which is discounted because it did not involve management and it ceased in 1975.

McDaniel

99. Mary and Carlo McDaniel, husband and wife, are partners of the general partnership, McDaniel Broadcasting Partnership. There are no limited partners. Mary owns 51% and Carlo owns 49% of the equity. Taking the evidence in a light most favorable to McDaniel's proposal, Mary and Carlo McDaniel will share equally in the management and control of the station. The 51/49 equity split is discounted as a factor that was arbitrarily selected so that the applicant would have the benefit of Mary's gender. The justification offered that Mary McDaniel had the expertise between the two to be designated the tie-breaker has not been satisfactorily established. *See* McDaniel PFC at 15, 27. But the circumstances of the marital relationship, Mrs. McDaniel having worked for 12 years in a company controlled by her husband, and the concession that Carlo McDaniel may have played a "slightly predominant role in conducting activities associated with the prosecution of MBP's [McDaniel's] application" support an inference that control at least will be shared. *See* McDaniel PFC at 29.

100. There remains to be considered whether the 100% integration of both partners would be supported by the evidence. Manatee argues that the tasks assigned to Carlo McDaniel are repetitive of those assigned to Mary McDaniel and therefore only Mary McDaniel should be credited with integration. *See* Manatee PFC at 30-32. But the evidence indicates otherwise. Mary McDaniel is proposed as the general manager and her husband Carlo is to be the station manager. In light of the above conclusion that control is shared by the two partners, she would not have ultimate authority over the station and personnel decisions would be made on an equal basis. She has assigned herself the specific duties of community relations, promotional affairs, and general business affairs. Carlo McDaniel, who has considerable broadcast experience, is assigned the duties of making the decisions in sales, and advertising but his duties in promotion may over-lap with those of his wife. He also will supervise the station's engineering. The responsibility for the station's editorial policy and program material is a joint assignment. The one overlap of duties with respect to promotion, a broad concept which has not been narrowly defined by the evidence of record, does not detract from the otherwise rational assignment of the managerial functions. None of the evidence argued by Manatee detracts substantially from the conclusion that Mary and Carlo McDaniel are 50/50 partners in the station's day-to-day operations. *See Daytona Broadcasting Co., Inc.*, 97 F.C.C. 2d 212, 220 (Review Bd 1984) (applicant awarded integration credit for the total percentage of its general partners who plan to work at the proposed facility); *aff'd* 101 F.C.C. 2d 1010 (Comm'n 1985).

101. However, the partnership agreement sets out the allocation of responsibility under which the McDaniel proposal must be assessed. Departure from a specific integration proposal fails to provide the required reasonable assurance of its effectuation. *Bradley, Hand and Triplett, supra.* The McDaniel partnership agreement provides that Mary McDaniel is the managing partner who will "delegate" responsibilities to her husband. It is significant to note that the agreement was not executed until a month after the application had been filed and Carlo McDaniel had been making key decisions on selecting a site, developing cost estimates and obtaining a commitment. The agreement is not tightly structured. For example, the partnership's books are equally accessible to each partner at all times and votes for new partners, or other partnership matters, may be taken orally, and the admission of a new partner requires the consent of both partners. Also, Ms. McDaniel admittedly had at least "transitory confusion" on the witness stand with regard to her duties. *See* McDaniel RPFC at 7 and M. McDaniel, Tr. 274, 276-77, 278-82. She testified that in an earlier unrelated partnership she and her husband were 50/50 partners and she was not a "managing partner" because titles were not important at that time. However, she recognized an importance in ascribing titles in the "F.C.C. business." (M. McDaniel, Tr. 269.) Collectively, this evidence supports the conclusion that Mary McDaniel was a "managing partner" in name only and that Mary and Carlo McDaniel intended to carry out their proposal as 50/50 partners. Therefore, there is no reasonable assurance that the integration proposal under the partnership will be carried out and thus, no integration credit is warranted for the McDaniel proposal.

102. In the event that credit were given for the proposal, it would be a credit for two equal general partners and Mary McDaniel would receive no gender credit. The civic activities of Mary McDaniel are too remote to warrant any credit. Carlo McDaniel would receive a slight to moderate credit for his more recent civic involvement. The partner would also receive credit for their residence within the service area.

Manatee

103. Manatee is a corporation with Mr. Hart as its president and with three vice-presidents, Mr. Hoffman, Ms. Bacon and Ms. Johnson, each of whom will be fully integrated into management. Mr. Hart will serve as president, Mr. Hoffman will serve as general manager, Ms. Bacon will serve as chief administrative officer, and Ms. Johnson will serve as community affairs director. Through these proposed positions, Manatee seeks to qualify for 100% integration credit. The Commission has applied the following relevant standard for making this determination:

> We are primarily interested in full-time participation - - -. In assessing proposals, we will also look to the positions which the participating owner will occupy, in order to determine the extent of their policy functions and the likelihood of their playing important roles in management. We will accord parti- cular weight to staff positions held by the owners, such as general manager, station manager, program director, business manager, director of news, sports, or public service broadcasting, and sales manager.

Policy Statement on Comparative Broadcast Hearings, 1 F.C.C. 2d 393, 395 (Comm'n 1965). For reasons stated below, Manatee only qualifies for 48.7% integration through the integration into management of Mr. Hoffman (41.5%) with a slight credit add on of for Mr. Hart (5.2%) and Ms. Johnson's full credit (2%) for a total quantitative integration credit of 48.7%.

104. Mr. Hart as Manatee's chief-executive officer has responsibility to generally supervise all departments to assure conformance with station policy with individual responsibility for insuring the station's financial survival. In that regard, he will prepare budgets, see that the station operates within the budgets that he sets, coordinate borrowing needs with lending institutions, and arrange for more capital if needed. (Manatee Exh. 3.) There is no provision for the position of chief executive officer in the *Policy Statement*, *supra*. Also, Gulf Coast argues that the duties of Mr. Hart and Mr. Hoffman would overlap. *See* Gulf Coast PFC at 22. The evidence supports that argument. As indicated above, Mr. Hart's duties are budget and finance oriented. But his specific duties will be to formulate policies and procedures that include finances, programming and personnel/EEO matters. (Manatee Exh. 3.) Those tasks do not require day-to-day management. In comparison, Mr. Hoffman's duties as general manager are the day-to-day implementation of administrative, financial, personnel and EEO matters. (Manatee Exh. 4.) The subject matters are nearly identical but Mr. Hart intends to focus on policy advice while Mr. Hoffman will address the same subjects on a day-to-day basic meaning hands-on application of policies. Mr. Hoffman has demonstrated through his past broadcast experience that he can handle these day-to-day responsibilities. *See* Para. 52, *supra*. No similar experience or expertise is noted for Mr. Hart. It is inconsistent and repetitious to contend for integration purposes that Mr. Hart will set the policies for finance, programming and personnel/EEO matters which are policies that are proposed to be set by the corporate directors as a body and will be managed daily by Mr. Hoffman. *See* Para. 48 above. Thus, Mr. Hoffman is the only shareholder who will implement those policies in a staff position of the kind envisioned by the *Policy Statement*. In contrast to Mr. Hoffman, Mr. Hart would primarily function as a roving ambassador between the board of directors and outside lenders. Manatee's budget needs would first need to be cleared by the entire board of directors and Mr. Hart, along with Mr. Hoffman, would participate in that process. But as Hart's role is described in the applicant's testimony, he appears to be more a consultant than a day-to-day manager. Therefore, Hart's participation will be accorded only a slight credit because Manatee has failed to sustain its burden of proof to show by substantial evidence that Hart's role is in accord with the integration standards under the *Policy Statement*. *See Deep South Radio, Inc. et al.*, 46 Radio Reg. 2d (P&F) 1657, 1658 (Comm'n 1980) (slight credit awarded 67.6% shareholder whose role in integration was inadequately described). Based on that authority, Mr. Hart will be awarded credit for 10% of his 51.5% equity position, or 5.2%. Mr. Hart's claims for qualitative credits also will be reduced accordingly.

105. Ms. Bacon is a 5% shareholder, vice-president and director, who is proposed to work full-time as the station's chief administrative officer. She is proposed to develop the station's equal employment opportunity program and she also is to insure compliance. She also has responsibilities in personnel matters. She will work in conjunction with Mr. Hoffman, the general manager, to develop job classifications and supervise recruitment and placement. *See* Para. 54, *supra*. But those activities will not be accepted for integration credit. Ms. Bacon's EEO tasks will be done on a day-to-day basis by Mr. Hoffman and on a consulting basis by Mr. Hart. Thus, Ms. Bacon's EEO activities would be redundant. With respect to Ms. Bacon's tasks in personnel matters she would be working in conjunction with the station's general manager and so she would not be independently managing personnel matters. Her tasks in personnel matters would be redundant with the work of Mr. Hoffman. Also, it is noted that there is nothing presented in Ms. Bacon's background and experience to indicate that she can handle these tasks more effectively than Mr. Hoffman. Since Ms. Bacon will not be credited with integration into management her qualitative evidence also will not be counted.

106. Ms. Johnson is a 2% shareholder, vice-president and director. She will be the station liaison with the community as Manatee's designated community affairs director. Ms. Johnson will be acting independently and she has been shown to have the contacts with the local community that gives her proposal credibility. While community affairs is not a managerial job cited in the *Policy Statement* that list of positions is not all-inclusive. *Compare Cleveland TV Corp.*, 91 F.C.C. 2d 1129, 1140 (Review Bd 1982) (the position of promotions manager was credited by the Review Board). Thus, Ms. Johnson's 2% ownership is counted quantitatively towards Manatee's integration credit and her local residence, civic activities, gender and race will be counted qualitatively.

107. Manatee is entitled to qualitative credits. Mr. Hart, Mr. Hoffman and Ms. Johnson all reside within the service area. Only slight credit is given to Mr. Hart for his residency and civic involvement because of the lesser integration credit that he received. Mr. Hoffman receives a moderate credit because he has lived in the Tampa area for fourteen years and he has actually moved to Bradenton, albeit after the "B" cutoff. Mr. Hoffman also has substantial civic activities which merit significant credit. Mr. Hoffman also qualifies for broadcast experience. Ms. Johnson receives a substantial credit for her local residency and her extensive involvement in local civic affairs. She also receives preferences for gender and race which are attributed to Manatee's proposal.

BBTC

108. The organizer of BBTC was the limited partner and 78% owner, MFR, Inc., acting through two of its controlling shareholders, Mr. Minkoff and Mr. Rugers. The general partner, Ms. Rogers, who owns 22% of the applicant's equity, was recruited by MFR's principals after an interview process in which she competed against at least one other person, also a Black female. When Ms. Rogers was presented with the partnership agreement to sign she read the draft agreement, discussed it with her husband and spoke with Mr. Buenzle by telephone about certain provisions. (Rogers, Tr. 572.) She also spoke with her husband and her husband's attorney about busines aspects of the proposed partnership before she signed. (Rogers, Tr. 565.) She consulted Mr. Buenzle, the communications attorney, and the engineer after she was brought on board as the general partner. But there is no evidence that counsel or the engineer were in contact with Minkoff or Rugers after Ms. Rogers assumed her role as general partner. She later was granted a bonus of 2% additional equity in the venture that I find to have enhanced her independence as general partner with a significant equity position. BBTC's counsel was known to Mr. Rugers and was proposed to Ms. Rogers but she could have rejected him as counsel. She relied on counsel for site selection and for obtaining the necessary engineering but there is no evidence that the limited partner had any

input to those decisions which were made by Ms. Rogers in conjunction with counsel. Discussions with a bank were undertaken by Ms. Rogers in conjunction with Mr. Minkoff but there is no evidence that Mr. Minkoff controlled the discussions.

109. It is recognized that Ms. Rogers was presented with more information by MFR in connection with her involvement as general partner than the opposing parties present in proposed findings. *Compare* Joyner PFC at 32-38. Ms. Rogers had received financial information about the principals of MFR and she relied on Ms. Glass for some assurances that MFR principals were reliable. That documentation was not furnished to Ms. Rogers until after she was chosen as general partner. *See* Para. 64, *supra*. But Ms. Rogers had detailed discussions with Mr. Minkoff about his substantial business holdings in the health care industry before she signed the agreement. (Rogers, Tr. 564.) Ms. Rogers has an obligation to make capital payments of $40,000. Thus far she has paid in $4,000 and has made some additional payments. *See* BBTC's PFC at 36-37. *Compare* BBTC's RPFC at 11 (commitment of $40,000). BBTC admits that Ms. Rogers was "chosen" and credits its presentation as being candid in admitting that the MFR principals were assuring themselves of Ms. Rogers' "responsibility and compatibility" before they invested their funds in the venture. *Id.* In fact, the limited partners even made a check on Ms. Rogers' creditworthiness and the currency of her tax returns. (Rogers, Tr. 564.) Such acts of due diligence are evidence of the careful consideration given to Ms. Roger's ability to act independently and to remain with the venture, all of which supports the proposal.

110. In order to more fully consider the proposed integration of Ms. Rogers, consideration will be given to her past employment record. She has been qualified as a registered nurse since 1965. She served in the Peace Corps and later moved to Bradenton in 1977. There she resided for 10 years and became active in local civic matters. *See* Para. 67-68 *supra*. In those years she received a degree in journalism and she worked in radio all of which evidences her interest in media employment or media ventures. She even purchased a local bi-monthly paper thus indicating a venturesome interest. In short, Ms. Rogers has shown that she is a risk taker. The fact that she moved from opportunity to opportunity does not support the conclusion sought by Joyner that Ms. Rogers' employment history is too unstable to rely on for a reasonable assurance that BBTC's integration proposal will persist. Also, although she left her full-time job in 1982, she has since worked non-contract jobs as a nurse from 24 hours to 40 hours per week.

111. Considering the circumstances under which Ms. Rogers was chosen to serve as BBTC's general partner, her conduct as general partner, as well as her employment history, it is concluded that BBTC's integration proposal provides the necessary reasonable assurance of fulfillment. *See Bradley, Hand and Triplett supra*, 89 F.C.C. 2d at 662. The case relied on by BBTC's opponents under which the *bona fides* of the proposal is seriously questioned is the case of *Magdalene Gunden Partnership*, 2 F.C.C. Rcd 5513 (Review Bd 1987). In that case, the limited partner recruited a general partner who in turn recruited a second general partner who was a Black female. The two general partners were given a 10% equity interest and the limited partner held 90%. The general partners paid-in only $1,766 and the limited partner paid all other costs. The limited partner obtained the financial letter and located the transmitter site. Neither of the general partners had any broadcast experience and in effect did nothing to advance the application. The Review Board discounted the actions of the general partner such as opening a bank account, writing the checks for expenditures, investigating compliance of other applicants with FCC requirements, and personally recruiting another general partner. *Id.* at 5516. In that case, the limited partnership agreement was signed 45 days after the application was filed and just two days before the "B" cut-off date. Here the facts are parallel but substantially different. Ms. Rogers is a 22% owner. She has paid $4,000 towards capital costs and she is committed to pay a total of $40,000. The partnership agreement was signed prior to filing albeit by only a factor of two days, and Ms. Rogers had an opportunity to consult her husband about the venture and to obtain the advice Ms. Glass before signing. The partnership agreement contains provisions that assure the insulation of limited partners and Ms. Rogers relied on counsel to obtain an engineer and to select a site. The only limited partnership involvement was with respect to obtaining the bank commitment. But Ms. Rogers participated in all discussions with the bank official. The evidence considered in its totality does not establish influence or control by the limited partner. *See Victory Media, supra* at 2074-75 (convencing evidence required by an opponent to show that limited partners are or will be in fact exercising influence or control). Most significantly, it was the general partner who executed and filed the application Form 301, who instructed counsel and the engineer, and who personally convinced a banker to make a commitment to BBTC. Also, it is significant that Ms. Rogers has broadcast and media experience and experience as a businesswoman who has owned her own small newspaper media businesses. *Compare Independent Masters, Ltd.*, 104 F.C.C. 2d 178 (Review Bd 1986) (Review Board accepted a 10% general partner who had been recruited by limited partner and who had prior broadcast experience). The Commission has held that activities subsequent to signing a limited partnership agreement such as filing and prosecuting an application are indicia of active involvement for integration purposes. *Tulsa Broadcasting Group*, 3 F.C.C. Rcd 4541 (Comm'n 1988).

112. Based on the above analysis, BBTC receives 100% integration credit as well as the gender and race preferences for Ms. Rogers. Also, through Ms. Rogers BBTC qualifies for a substantial credit for local Bradenton residency and a substantial credit for local civic involvement. However, because of the interspersed experience of Ms. Rogers in radio broadcast work and the fact that she was never involved in broadcast management, BBTC will receive only a slight credit for past broadcast experience.

Joyner

113. Joyner is a limited partnership and proposes its integration through general partner Arthenia L. Joyner. She has a 20% equity interest. There are four limited partners each owning 20% of the venture. But only Ms. Joyner will be integrated into the station's operations and she will be full-time general manager.

114. Ms. Joyner is a practicing attorney. She has been a sole practitioner since her graduation from law school in 1968. Thus, she is capable of managing a small business although she has no broadcast experience. Her credibility has been analyzed above and she is accepted as a credible

witness. *See* paras. 78-79, *supra*. The facts establish that in a fashion similar to Ms. Rogers, Ms. Joyner was solicited about an opportunity to serve as general partner/general manager of a broadcast venture in Bradenton. Mr. Regale's role is not clear from the evidence. He may have been calling as a prospective investor but he later refused the opportunity. Or she may have been contacted at the request of Joyner's communications counsel who knew of the Bradenton allocation and knew Regale. Whatever the motivation on Regale's part. he knew Ms. Joyner and he also knew Joyner's communications counsel. He called Ms. Joyner. She wanted more information and she asked to speak with a communications attorney. Mr. Regale put her in touch with Mr. Taylor. After speaking with Mr. Taylor, Ms. Joyner contacted about 10 prospective limited partner investors but she did not enlist anyone else before talking again with Mr. Taylor. After talking with him, Ms. Joyner again sought investors and ultimately found four whom she had known for about 10 years. These facts support the independence of Ms. Joyner at the promotion stage of the venture and they lend credibility to the Joyner proposal.

115. Under circumstances that are substantially similar to Ms. Rogers (paras. 72-77), Joyner is entitled to 100% integration credit for Ms. Joyner's full-time participation as general manager and she receives preference for her gender and for her race. She will receive a moderate credit for her residence since 1949 in the service area with a slight enhancement for her timely promise to move to Bradenton if Joyner is awarded the permit. She has no broadcast experience but she has earned creditable civic service in the service area.

Gulf Coast

116. As indicated above, Gulf Coast is not basically qualified as an applicant because of a failure to disclose its real party-in-interest. On a contingent consideration, however, Mr. Berkman would receive credit for 100% integration and he would also receive a moderate local residency credit for his residency within the service area for thirteen years. He would also be entitled to a moderate credit for civic involvement but no preference for race. Through Mr. Berkman, Gulf Coast would receive a substantial credit for past broadcast experience.

ULTIMATE CONCLUSIONS

117. All outstanding air hazard issues have been resolved favorably to applicants Manatee and BBTC. Gulf Coast is basically unqualified for failing to disclose a real party-in-interest. If Gulf Coast's disclosures and failures to disclose were unintentional, its proposal would be rejected on an alternative ground of failure to provide reasonable assurance of its effectuation. On either theory, Gulf Coast receives a substantial demerit for media diversification because of the ownership of the parent company ACC. The integration proposals of Skylight and McDaniel are rejected because they have failed to provide reasonable assurances that those proposals would be effected if an award were made to either applicant.

118. Manatee receives only a 48.7% quantitative integration credit and therefore finishes fourth in comparison to the other finalists. Kramer receives 100% integration credit for Ms. Kramer and also a gender preference. But Ms. Kramer offers no broadcast experience and claims no local residency or local civic involvement. She receives only a slight credit for her promise to move to Bradenton. She finishes in third place.

119. BBTC and Joyner are the ultimate finalists to be compared. Neither applicant received a diversification demerit and both applicants qualify for a racial and a gender preference.[12] Also, each applicant is credited with 100% quantitative integration into management. Thus, the measurable distinctions are in the respective qualitative merits. Ms. Rogers has been a resident of the Bradenton community for the past ten years engaged in civic activities and such local residency and civic interest warrants a substantial enhancement credit. *West Michigan Broadcasting Company* v. *F. C. C.*, *supra* at 608; *Newton Television Limited, et al.*, 3 F.C.C. Rcd 553, 555 (Review Bd 1988). Ms. Joyner has been a resident of the service area for 38 years and she has been engaged in civic activities for which she receives a moderate enhancement credit. *Id.* Joyner also receives a slight additional enhancement by virtue of Ms. Joyner's promise to move to Bradenton. While the 17 activities cited by Ms. Joyner are by count more than the 6 activities allowed for Ms. Rogers, the Review Board has cautioned that the local civic activities are but a "barometer of an integrated principal's experience knowledge of and interest in the contemporary problems, needs and interests of the proposed station's service area." *Id.* Also, the fact that the civic activities of both Rogers and Joyner covered the service area and were not just limited to the community of license is a barometric-type credit for both. *See Stone* v. *F. C. C.*, 466 F.2d 316, 327 (D.C. Cir. 1972) (broadcast licensee has obligation to meet needs and interests of entire service area and particularly with respect to television stations). The quality of Ms. Rogers' activities are acceptable for full credit: Manatee County Chapter of NAACP and service as chair of Voter Registration Program; Manatee County Blood Bank; service on Manatee and Sarasota Public Relations Committees for the United Negro Fund; American Cancer Society of Manatee County; and member of Parish Council service on Peace and Justice Committee and volunteer for Immigration Assimilation Project through a Bradenton church affiliation. *Compare Newton Television Limited, supra* at 555-56 and 560 n. 15 (comparison of quality and non-quality local activities). These are significant civic activities which when considered in conjunction with Ms. Rogers' community residence entitle BBTC to a substantial credit. The 17 civic activities cited by Ms. Joyner show her to have a broad awareness of the civic and political matters which are of interest to the service area. But since her residence is outside the community Joyner is entitled to no more than a moderate enhancement credit. Even with a slight additional enhancement for Joyner's commitment to relocate to Bradenton, at this point in time Ms. Rogers has accumulated greater qualitative merit. Finally, Ms. Rogers is entitled to an additional slight credit for her broadcast experience while Ms. Joyner has no such experience. Therefore, the applicable comparative standards require that an award be made to BBTC, with Joyner finishing a close second.

ORDER

Accordingly, IT IS ORDERED that unless an appeal from this Initial Decision is taken by a party, or unless the Commission reviews this Initial Decision on its own motion,[13] the applications of Renee Marie Kramer (Fil

No. BPCT-870731KV), Skylight Broadcasting, Inc. (File No. BPCT-870731KX), Carlo B. McDaniel and Mary S. McDaniel d/b/a McDaniel Broadcasting Partners (File No. BPCT-870731KY), Manatee Television, Inc. (File No. BPCT-870731LA), Joyner Communications Limited Partnership (File No. BPCT-870731LC), and Gulf Coast Telecasters Limited Partnership (File No. BPCT-870731LO) ARE DENIED and the application of Bradenton Broadcast Television Company, Ltd. for a construction permit for a new Television Station at Bradenton, Florida (File No. BPCT- 870731LB) IS GRANTED.

FEDERAL COMMUNICATIONS COMMISSION

Richard L. Sippel
Administrative Law Judge

FOOTNOTES

[1] The application of DeSoto Broadcasting, Inc. (File No. BPCT-870731LD) was dismissed on that applicant's own request. *See Order*, FCC 88M-258, released February 3, 1988. The application of Florida Manatee TV Broadcast Associates (File No. BPCT-870731LP) was also voluntarily dismissed under *Order*, FCC 88M-1738, released June 3, 1988. The application of Gulf Coast Broadcasting Ltd. (File No. BPCT-870730KL) was dismissed for failure to prosecute. *See Order*, FCC 88M-355, released February 11, 1988.

[2] Ms. Kramer testified that her family maintains a vacation home within the proposed service area. (Kramer Exh. 1.) But her testimony that she has been a "temporary resident" of the service area was stricken as irrelevant. (Kramer, Tr. 71.) In light of that ruling, Ms. Kramer correctly makes no reference in her findings to any credit for a local residence based on her family's vacation home.

[3] Other civic activities of Ms. McDaniel are irrelevant. She was active in local PTAs at schools which her children were attending in and around 1963. She had a clear personal interest in that work and it is too remote in time to be counted. In 1984, she was a volunteer worker in a toy collection effort for needy children in Melbourne, Florida, a city that is outside the service area. (M. McDaniel, Tr. 270.)

[4] Carlo McDaniel developed a reading aid (Telereader) over 25 years ago. That event is too remote in time. Also, the evidence does not establish any relationship of the Telereader to the service area. His work in connection with the Miss Black Florida Beauty Pageant and at the Job Fair at the Florida State Fair in the 1970s were related to Mr. Daniel's business and therefore it will not be credited. (C. McDaniel, Tr. 306-308.)

[5] Credit cannot be assessed for the work in Pinellas and Pasco counties, or on the golf tournament because there is no affirmative showing of geographical relevance. Similarly, there is no geographical relevance shown for the civic activities described at Manatee Exh. 3 at pp. 5-6. It may be clear to Mr. Hart and to Manatee that the described civic duties show a civic awareness of the proposed coverage area but it is not made clear as a matter of record on which findings are made. The Presiding Judge is under no obligation to search the record for geographical relevance of cited civic experience.

[6] Mr. Hoffman did move to Bradenton but his move was after the "B" cutoff date. *See* Manatee's PFC at 13. He now resides at 2706 10th Street West, Palmetto, Florida which is represented to be within the proposed Grade A contour. (Manatee Exh. 4 at pp. 1-2.)

[7] Credit for residency in Arcadia, Florida is sought by Manatee but is rejected because its geographical relevancy is not noted.

[8] The evidence proferred by BBTC does not establish the geographic relevance of the "Habitat for Humanity, Manasota." *See* BBTC's PFC at 50. Thus, as with other applicants, no credit will be given for that item. *Compare* fn. 5, *supra*.

[9] Because of a failure to show geographical relevancy the following civic proposals of Joyner are rejected: Criminal Justice Planning Council of Hillsborough Country; District 6 Nursing Home Omnbudsman Committee of Hillsbourough County; State Long Term Care Omnbudsman Committee; Florida Probation and Parole Qualifications Selection Committee; Citizen Advisory Committee Hillsborough County School Board; Charmettes, Inc.; Hillsborough Community Housing Resource Board; Delta Sigma Theta Sorority, Inc.; Charter Review Board of Hillsborough County; and Hillsborough County Attorney Search Committee. *Compare* fn. 5, *supra*.

[10] *Compare Leininger - Geddes Partnership*, 2 F.C.C. Rcd 3199 (Review Bd 1987) (attorney who has active trial practice which he did not intend to give up was not credited with an integration pledge).

[11] Because of a failure to show relevance to civic activity in the coverage area, no credit is assigned to Mr. Berkman's activities as Friends of the Library for Hillsborough County, chairman of the Security Committee for Sweetwater Homeowners Associations in Tampa (failure to describe the civic nature of the group), March of Dimes Gulf Committee at Hillsborough, and the NFL Alumni Association. *Compare* fn. 5, *supra*.

[12] The recent decision by the United States Court of Appeals for the D.C. Circuit is noted which holds that a minority race preference in a distress sale situation violates the equal protection clause of the Constitution. *See Shurberg Broadcasting of Hartford, Inc.* v. *F. C. C.*, _____ F.2d _____, Slip Op. Appeal No. 84-1600, decided March 31, 1989. But the court specifically left undecided the Constitutional issue concerning gender and/or race preferences in comparative broadcast hearing. *See* Slip Op. at 11 (since race is only one consideration among many in comparative licensing, those proceedings are distinguishable from the distress sale policy). *Compare West Michigan Broadcasting Company v. F.C.C., supra*.

[13] This *Initial Decision* shall become effective and this proceeding shall be terminated 50 days after its public release if exceptions are not filed within 30 days thereafter, unless the Commission elects to review the case on its own motion. 47 C.F.R. §1.276(d).

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

AMERITECH OPERATING COMPANIES
Revisions to Tariff F.C.C. No. 2

Transmittal Nos. 267 and 273

ORDER

Adopted: April 13, 1989; Released: April 17, 1989

By the Chief, Common Carrier Bureau:

1. On February 23 and February 24, 1989, the Ameritech Operating Companies (Ameritech) filed the captioned tariff revisions which propose individual case basis (ICB) rates and charges for DS3 high capacity services. The proposed revisions were originally scheduled to become effective on March 20 and March 31, 1989, respectively, but the effective dates were subsequently deferred to May 4 and May 15, 1989. On March 17, 1989, Ameritech filed additional revisions to its tariff that propose a generalized rate structure for DS3 service.[1]

2. On April 6, 1989, Ameritech filed an application for special permission in which it requests waiver of Section 61.58 of the Commission's Rules, 47 C.F.R. § 61.58, in order to advance the effective date of the captioned tariff revisions.[2] Ameritech asserts that the rates proposed in Transmittals 267 and 273 are completely consistent with the rate structure and levels proposed for Ameritech's generalized DS3 service offering in Transmittal 287. Ameritech states further that the minimum service periods proposed for its ICB offerings in Transmittals 267 and 273 have been adjusted to be consistent with its proposed generalized DS3 tariff.

3. On March 28, 1988, the Bureau released an Order initiating an investigation of a number of local exchange carriers' (LEC) proposed ICB rates, designating for investigation issues concerning the LECs' continued use of ICB rates for DS3 offerings.[3] Transmittals 267 and 273 raise the same issues as those transmittals subject to our *Designation Order*. Therefore, the instant transmittals will be subject to the outcome of that investigation. In view of the fact that Ameritech has made the proposed ICB rates consistent with its pending generalized filing, we will grant its application and allow it to advance the effective date of these proposed revisions on not less than one day's notice.

4. Accordingly, IT IS ORDERED that the Ameritech Operating Companies Tariff F.C.C. No. 2, Transmittals 267 and 273, are subject to the investigation instituted in CC Docket No. 88-136.

5. IT IS FURTHER ORDERED that the Ameritech Operating Companies may file tariff revisions, as requested in Application No. 72, to be effective on not less than one day's notice, in order to advance the effective date of the above-referenced transmittals. For this purpose, we waive Sections 61.56, 61.58, and 61.59 of the Commission's Rules, 47 C.F.R. §§ 61.56, 61.58, 61.59, and assign Special Permission No. 89-275.

6. IT IS FURTHER ORDERED that, pursuant to Section 204(a) of the Communications Act, 47 U.S.C. § 204(a), and Section 0.291 of the Commission's Rules, 47 C.F.R. § 0.291, the subject tariff revisions are suspended for one day.

7. IT IS FURTHER ORDERED that, pursuant to Sections 4(i) and 204(a) of the Communications Act, 47 U.S.C. §§ 154(i), 204(a), and Section 0.291 of the Commission's Rules, 47 C.F.R. § 0.291, the Ameritech Operating Companies shall keep accurate account of all amounts received pursuant to rates for DS3 services filed under Transmittals 267 and 273.

FEDERAL COMMUNICATIONS COMMISSION

Gerald Brock
Chief, Common Carrier Bureau

FOOTNOTES

[1] *See* Ameritech Operating Companies, Tariff F.C.C. No. 2, Tr. No. 287, filed Mar. 17, 1989.

[2] Ameritech Operating Companies, Application No. 72, filed Apr. 6, 1989.

[3] Local Exchange Carriers' Individual Case Basis DS3 Service Offerings, CC Docket No. 88-136, Order Designating Issues for Investigation, 3 FCC Rcd 2582 (1988) (*Designation Order*). *See also* Supplemental Order Designating Issues for Investigation, CC Docket No. 88-136, 3 FCC Rcd 6066 (1988); Public Notice, Network Communications, Inc., Files Comments on Individual Case Basis Rates for DS3 Services, CC Docket No. 88-136, 4 FCC Rcd 846 (1989).

Before the
Federal Communications Commission
Washington, D.C. 20554

PUBLIC NOTICE

Released: April 19,1989

COORDINATION OF ASSIGNMENTS IN THE 2500-2686 MHZ BAND WITHIN 80 KM OF THE UNITED STATES OF AMERICA/CANADA BORDER

On March 23, 1989, a general understanding on coordinating assignments in the 2500-2686 MHz band along the United States of America / Canada border was signed by the Federal Communications Commission and the Department of Communications of Canada.

The understanding, which is attached, provides that assignments / stations meeting certain technical requirements will not require coordination. Rather, only notification of the use of the assignment will be necessary. Notification will reduce the time required to process applications on both sides of the border. Application for stations that do not meet the stipulated technical requirements will continue to be subject to the full coordination process. Applicants for stations within 80 km of the border must indicate whether or not they comply with the technical requirements of the understanding. Those claiming compliance must demonstrate such in their application.

The Commission intends to institute a rule making proceeding to amend Rules Parts 21, 74 and 94 to reflect this understanding.

For further information, contact Donald Draper Campbell, of the Office of Engineering and Technology, at (202) 653-8113.

FEDERAL COMMUNICATIONS COMMISSION

- - - - -

ATTACHMENT

General FCC/DOC understanding concerning the coordination of the 2500-2686 MHz band within 80 km (50 miles) of the United States of America / Canada border

This document describes a general understanding between the Federal Communications Commission (FCC), USA, and the Department of Communications (DOC), Canada, concerning the mutual use of the 2500-2686 MHz band within 80 km of the United States of America / Canada border. This understanding is based upon the following technical principles.

1. Both FCC and DOC agree that both administrations should have access to the full 31 channels of the 2500-2686 MHz band (see TABLE 1) whenever practical.

2. Initially both FCC and DOC will endeavor to avoid co-channel assignment of frequencies to the greatest extent possible. Timely notification of proposed technical operating parameters to the other administration for information purposes is required for all assignments within 80 km of the border.

3. Both FCC and DOC agree to require the use of cross-polarization for assignments within 80 km of the border. In general, the United States assignments shall use horizontal polarization of the electric field and Canadian assignments shall use vertical polarization of the electric field.

4. Both FCC and DOC agree to require the use of non-precision frequency offsets for assignments within 50 km of the border. The United States assignments shall operate on the nominal channel frequencies. Canadian assignments shall use the nominal channel frequencies ± 10 kHz. The frequency tolerance for non-precision offset shall be within ± 500 Hz.

5. Both FCC and DOC agree that a reference receive antenna pattern for coordination purposes shall be based on the following values -- Nominal gain: 22 dBi; 3 dB beamwidth: 12^0; Front-to-back ratio: 28 dB; Boresight cross-polarization: 26 dB; 180^0 cross-polarization: 35 dB. (See FIGURE 1.)

6. Both FCC and DOC agree to establish a power flux density (pfd) of -70 dBw/m^2 as the coordination threshold at the border. Computation of the pfd shall be based on free space calculation. If the -70 dBw/m^2 threshold is not exceeded and the technical parameters specified in paragraphs 3 and 4 are observed, coordination of such assignments within 80 km of the border would not be required. However, notification of operating parameters of such assignments should be done in a timely manner, see (2) above.

7. Both FCC and DOC agree that in any area where the pfd limit or the above parameters are not observed, an administration may, after coordination, assign up to a maximum of 12 channels provided no harmful interference is caused to any existing assignments across the border. Each administration should attempt to minimize the pfd spillover across the border on these channels in order to increase the possibility of spectrum usage by the other administration. Beyond this channel threshold, the above pfd and technical parameters shall be observed on the remaining channels unless other coordination arrangements have been agreed upon in specific cases.

8. Both FCC and DOC agree that the above conditions shall not apply to stations listed in ANNEX A.

9. Both FCC and DOC agree that these principles should be reviewed within 2 years from the date of the understanding.

10. Both FCC and DOC agree that for the Buffalo/St. Catherines-Niagara Falls and Bellingham/Vancouver areas, additional technical consideration other than those noted above may be required. To this end, discussions will start immediately. Until these discussions are concluded, coordination requests for the Buffalo/St. Catherines-Niagara Falls and Bellingham/Vancouver areas will not be processed unless such requests meet the technical parameters and pfd limits specified in paragraphs 3, 4, and 6. For Detroit/Windsor Metropolitan areas, refer to Annex B.

Robert A. Gordon
Assistant Deputy Minister
Spectrum Management and
Regional Operations
Department of
Communications

Thomas P. Stanley
Chief Engineer
Office of Engineering
and Technology
Federal Communications
Commission

ANNEX B

Provisions concerning usage in the Detroit/Windsor metropolitan areas

- Stations using channel groups A, B, C, and D, and channels G-3 and G-4 in the Detroit area shall be located at the Motower Building (42N2713, 083W0950), utilize horizontal polarization, and comply with all the other requirements of the Understanding.

- Stations using channel groups E, F, and H, and channels G-1 and G-2 in the Detroit area shall be located at the Renaissance Building (42N1945, 083W0225), utilize vertical polarization, and comply with all the other requirements of the Understanding.

- Stations using channel groups A, B, C, D, E, F, G, and H in the Windsor area shall use polarization opposite to that used by the corresponding channels assigned to the stations in the Detroit area and comply with all other requirements of the Understanding.

Channel Designator	Frequency (MHz)
A-1	2500 - 2506
B-1	2506 - 2512
A-2	2512 - 2518
B-2	2518 - 2524
A-3	2524 - 2530
B-3	2530 - 2536
A-4	2536 - 2542
B-4	2542 - 2548
C-1	2548 - 2554
D-1	2554 - 2560
C-2	2560 - 2566
D-2	2566 - 2572
C-3	2572 - 2578
D-3	2578 - 2584
C-4	2584 - 2590
D-4	2590 - 2596
E-1	2596 - 2602
F-1	2602 - 2608
E-2	2608 - 2614
F-2	2614 - 2620
E-3	2620 - 2626
F-3	2626 - 2632
E-4	2632 - 2638
F-4	2638 - 2644
G-1	2644 - 2650
H-1	2650 - 2656
G-2	2656 - 2662
H-2	2662 - 2668
G-3	2668 - 2674
H-3	2674 - 2680
G-4	2680 - 2686

TABLE 1: List of Channel Designator and Frequencies.

ANNEX A

List of United States Assignments

Call Sign	Freq (MHz)	Lat	Lon	City	St	BW/EM	P	Tx Pwr (W)	Ant Gain	Beam-width	Azmuth	Gnd ft	Ant ft
WLK358	2599	454024	684308	Millinocket	ME	5M75C3F	H	10.000	0.00	360.0	0.0	450	170
WLK358	2611	454024	684308	Millinocket	ME	5M75C3F	H	10.000	0.00	360.0	0.0	450	170
WLK358	2623	454024	684308	Millinocket	ME	5M75C3F	H	10.000	0.00	360.0	0.0	450	170
WLK358	2635	454024	684308	Millinocket	ME	5M75C3F	H	10.000	0.00	360.0	0.0	450	170
WBK219	2503	444140	732756	Plattsburgh	NY	5M75C3F	V	10.000	18.90	140.0	230.0	175	135
WHR700	2659	443634	750957	Canton	NY	5M75C3F	H	10.000	28.00	0.0	205.4	425	178
WHR699	2671	441943	751505	Edwards	NY	5M75C3F	V	10.000	31.40	0.0	235.5	650	187
WHR703	2683	440930	751915	Harrisville	NY	5M75C3F	V	10.000	28.00	0.0	329.5	780	138
WHR701	2503	441511	752259	Balmat	NY	5M75C3F	H	10.000	12.70	360.0	0.0	840	182
WHR701	2503	441511	752259	Balmat	NY	5M75C3F	V	10.000	28.00	0.0	25.3	840	178
WHR701	2515	441511	752259	Balmat	NY	5M75C3F	H	10.000	12.70	360.0	0.0	840	182
WHR701	2515	441511	752259	Balmat	NY	5M75C3F	V	10.000	28.00	0.0	25.3	840	178
WHR701	2527	441511	752259	Balmat	NY	5M75C3F	H	10.000	12.70	360.0	0.0	840	182
WHR701	2527	441511	752259	Balmat	NY	5M75C3F	V	10.000	28.00	0.0	25.3	840	178
WHR701	2539	441511	752259	Balmat	NY	5M75C3F	H	10.000	12.70	360.0	0.0	840	182
WHR701	2539	441511	752259	Balmat	NY	5M75C3F	V	10.000	28.00	0.0	25.3	840	178
WHR698	2647	442029	752756	Gouverneur	NY	5M75C3F	V	10.000	28.00	0.0	151.5	450	172
KRV45	2557	430933	773348	Rochester	NY	5M75C3F	H	10.000	13.00	360.0	0.0	463	270
KRV45	2581	430933	773348	Rochester	NY	5M75C3F	H	10.000	13.00	360.0	0.0	463	270
KRV45	2569	430953	773348	Rochester	NY	5M75C3F	H	10.000	13.00	360.0	0.0	463	270
WAX30	2503	430514	774032	Rochester	NY	5M75C3F	H	10.000	15.00	0.0	45.0	536	132
WDG55	2647	425720	784901	Buffalo	NY	5M75C3F	H	10.000	13.00	360.0	0.0	690	150
WDG55	2659	425720	784901	Buffalo	NY	5M75C3F	H	10.000	13.00	360.0	0.0	690	150
WDG55	2671	425720	784901	Buffalo	NY	5M75C3F	H	10.000	13.00	360.0	0.0	690	150
WDG55	2683	425720	784901	Buffalo	NY	5M75C3F	H	10.000	13.00	360.0	0.0	690	150
KWE21	2503	425856	785137	Kenmore	NY	5M75C3F	H	1.000	13.00	360.0	0.0	600	120
KWE21	2515	425856	785137	Kenmore	NY	5M75C3F	H	1.000	13.00	360.0	0.0	600	120
WAQ310	2551	422508	791840	Fredonia	NY	5M75C3F	H	10.000	11.20	220.0	300.0	860	180
WAQ310	2551	422508	791840	Fredonia	NY	5M75C3F	V	10.000	27.00	0.0	229.0	860	170
WHN700	2509	415139	804046	Gageville	OH	5M75C3F	H	10.000	15.70	360.0	0.0	870	360
WHR450	2659	412728	812934	Beachwood	OH	5M75C3F	H	10.000	13.00	360.0	0.0	1195	365
WHR450	2683	412728	812934	Beachwood	OH	5M75C3F	H	10.000	13.00	360.0	0.0	1195	365
WHR675	2563	413000	814058	Cleveland	OH	5M75C3F	V	1.000	31.40	0.0	106.0	680	68
WHR675	2587	413000	814058	Cleveland	OH	5M75C3F	V	1.000	31.40	0.0	106.0	680	68
WHK375	2653	412959	814109	Cleveland	OH	5M75C3F	V	10.000	16.00	360.0	0.0	677	383
WGM96	2629	412144	814156	Parma	OH	5M75C3F	H	1.000	31.00	0.0	311.0	1122	35
KNZ60	2503	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2509	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2515	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2521	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2527	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2533	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2539	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2545	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2551	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2563	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WAJ20	2575	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600

ANNEX A, con't

List of United States Assignments

Call Sign	Freq (MHz)	Lat	Lon	City	St	BW/EM	P	Tx Pwr (W)	Ant Gain	Beam-width	Azmuth	Gnd ft	Ant ft
WAJ20	2587	412302	814206	Parma	OH	5M75C3F	H	50.000	9.40	360.0	0.0	1020	600
WHJ951	2665	412302	814206	Parma	OH	5M75C3F	H	10.000	10.10	360.0	0.0	1020	600
WHR776	2557	412302	814206	Parma	OH	5M75C3F	H	10.000	15.70	360.0	0.0	1020	604
WHR776	2569	412302	814206	Parma	OH	5M75C3F	H	10.000	15.70	360.0	0.0	1020	604
WHR776	2581	412302	814206	Parma	OH	5M75C3F	H	10.000	15.70	360.0	0.0	1020	604
WHR776	2593	412302	814206	Parma	OH	5M75C3F	H	10.000	15.70	360.0	0.0	1020	604
WLK306	2605	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK306	2617	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK306	2629	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK306	2641	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK310	2599	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK310	2611	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK310	2623	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
WLK310	2635	412302	814206	Parma	OH	5M75C3F	H	10.000	0.00	360.0	0.0	1020	600
KA88717	2659	412218	814248	Cleveland	OH	5M75C3F	H	0.000	0.00	0.0	0.0	0	0
KDX68	2599	412510	814254	Cleveland	OH	5M75C3F	V	1.000	27.00	0.0	175.0	790	80
KDX68	2611	412510	814254	Cleveland	OH	5M75C3F	V	1.000	27.00	0.0	175.0	790	80
KDX68	2623	412510	814254	Cleveland	OH	5M75C3F	V	1.000	27.00	0.0	175.0	790	80
KDX68	2635	412510	814254	Cleveland	OH	5M75C3F	V	1.000	27.00	0.0	175.0	790	80
KDX68	2647	412510	814254	Cleveland	OH	5M75C3F	H	1.000	27.00	0.0	175.0	790	80
KDX68	2659	412510	814254	Cleveland	OH	5M75C3F	H	1.000	27.00	0.0	175.0	790	80
KDX68	2671	412510	814254	Cleveland	OH	5M75C3F	H	1.000	27.00	0.0	175.0	790	80
KHR35	2677	412447	815004	Cleveland	OH	5M75C3F	V	0.002	26.00	6.5	203.0	792	56
WHR777	2647	412448	820421	Elyria	OH	5M75C3F	V	10.000	18.20	0.0	270.0	697	291
WHR777	2659	412448	820421	Elyria	OH	5M75C3F	V	10.000	18.20	0.0	270.0	697	291
WHR777	2671	412448	820421	Elyria	OH	5M75C3F	V	10.000	18.20	0.0	270.0	697	291
WHR777	2683	412448	820421	Elyria	OH	5M75C3F	V	10.000	18.20	0.0	270.0	697	291
WHR517	2569	412157	820552	Elyria	OH	5M75C3F	V	10.000	13.00	360.0	0.0	725	210
WHR517	2593	412157	820552	Elyria	OH	5M75C3F	V	10.000	13.00	360.0	0.0	725	210
WHR610	2557	425938	824336	Emmett	MI	5M75C3F	H	10.000	14.00	360.0	0.0	760	260
WHR610	2569	425938	824336	Emmett	MI	5M75C3F	H	10.000	14.00	360.0	0.0	760	260
WHR610	2581	425938	824336	Emmett	MI	5M75C3F	H	10.000	14.00	360.0	0.0	760	260
WHR629	2647	425937	824348	Emmett	MI	5M75C3F	V	10.000	15.70	360.0	0.0	760	300
WHR629	2659	425937	824348	Emmett	MI	5M75C3F	V	10.000	15.70	360.0	0.0	760	300
WHR616	2509	412142	824525	Castalia	OH	5M75C3F	V	10.000	13.00	360.0	0.0	725	147
WHR616	2533	412142	824525	Castalia	OH	5M75C3F	V	10.000	13.00	360.0	0.0	725	147
WHR668	2599	412242	831317	Fremont	OH	5M75C3F	H	10.000	31.50	0.0	92.7	655	25
WHR668	2623	412242	831317	Fremont	OH	5M75C3F	H	10.000	31.50	0.0	92.7	655	25
WHR668	2599	412242	831317	Fremont	OH	5M75C3F	H	10.000	14.00	150.0	112.5	630	25
WHR668	2623	412242	831317	Fremont	OH	5M75C3F	H	10.000	14.00	150.0	112.5	630	25
WHR722	2509	413927	832555	Toledo	OH	5M75C3F	V	10.000	16.00	220.0	270.0	594	39
WHR722	2521	413927	832555	Toledo	OH	5M75C3F	V	10.000	16.00	220.0	270.0	594	39
WHR722	2533	413927	832555	Toledo	OH	5M75C3F	V	10.000	16.00	220.0	270.0	594	39
WHR722	2545	413927	832555	Toledo	OH	5M75C3F	V	10.000	16.00	220.0	270.0	594	39

ANNEX A, con't

List of United States Assignments

Call Sign	Freq (MHz)	Lat	Lon	City	St	BW/EM	P	Tx Pwr (W)	Ant Gain	Beam-width	Azmuth	Gnd ft	Ant ft
WHR924	2533	424620	832758	Springfield Twp	MI	5M75C3F	H	10.000	12.70	360.0	0.0	1100	285
WHR924	2545	424620	832758	Springfield Twp	MI	5M75C3F	H	10.000	12.70	360.0	0.0	1100	285
WHR633	2509	423455	833634	Milford	MI	5M75C3F	V	10.000	12.70	360.0	0.0	940	292
WHR633	2521	423455	833634	Milford	MI	5M75C3F	V	10.000	12.70	360.0	0.0	940	292
WHR617	2509	412221	833830	Bowling Green	OH	5M75C3F	H	10.000	14.00	180.0	86.0	693	151
WHR617	2533	412221	833830	Bowling Green	OH	5M75C3F	H	10.000	14.00	180.0	86.0	693	151
WHR550	2503	413730	833920	Toledo	OH	5M75C3F	H	10.000	15.70	360.0	0.0	625	363
WHR550	2515	413730	833920	Toledo	OH	5M75C3F	H	10.000	15.70	360.0	0.0	625	363
WHR550	2527	413730	833920	Toledo	OH	5M75C3F	H	10.000	15.70	360.0	0.0	625	363
WHR550	2539	413730	833920	Toledo	OH	5M75C3F	H	10.000	15.70	360.0	0.0	625	363

NOTES: Antenna pattern/beamwidth: 31.0 dBi gain -> 4.4^0 beamwidth
28.0 dBi gain -> 6.3^0 beamwidth

ANNEX A, con't

List of Canadian Assignments

Freq (MHz)	Lat	Lon	City	PR	BW/EM	P	Tx Pwr (W)	Ant Gain	Azmuth	Gnd ft	Ant ft
2605.00	433947	800343	Action	ON	6M00J8FNF	H	100.0	13.0	OMNI	1436	1360
2593.00	495912	811408	London	ON	5250A5C	H	10.0	9.0	OMNI	1120	820
2581.00	495912	811408	London	ON	750FE	H	10.0	9.0	OMNI	1120	820
2690.00	541256	1292386	McLean Mtm	BC	18344F9		2.5	38.8	280	3830	3700
2557.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2569.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2581.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2587.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2593.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2599.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2605.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2611.00	493343	970534	Niverville	MB	6M00C3FNN		5.0	16.7	55/145	917	767
2503.00	452258	754159	Ottawa	ON	6M00J8FNF	H	1.0	31.0	219/74	459	235
2587.25	452258	754159	Ottawa	ON	6000A5CF3	H	1.0	31.0	32	466	235
2627.25	452258	754159	Ottawa	ON	6000A5CF3	H	1.0	31.0	220	466	235
2570.00	502646	1041837	Regina	SK	18030F9		2.4	40.8	323.17	2122	1928
2557.00	435325	792343	Toronto	ON	6M00J8FNF		10.0	17.2	OMNI	1080	530
2599.00	435325	792343	Toronto	ON			10.0				
2605.00	435325	792343	Toronto	ON	6M00J8FNF	H	10.0	17.2	OMNI	1080	530
2575.00	495312	971606	Winnipeg	MB	6M00J8FNF	H	10.0	8.2	OMNI	872	770
2587.00	495312	971606	Winnipeg	MB	6000A5CF3		2.9	9.6	OMNI	820	790

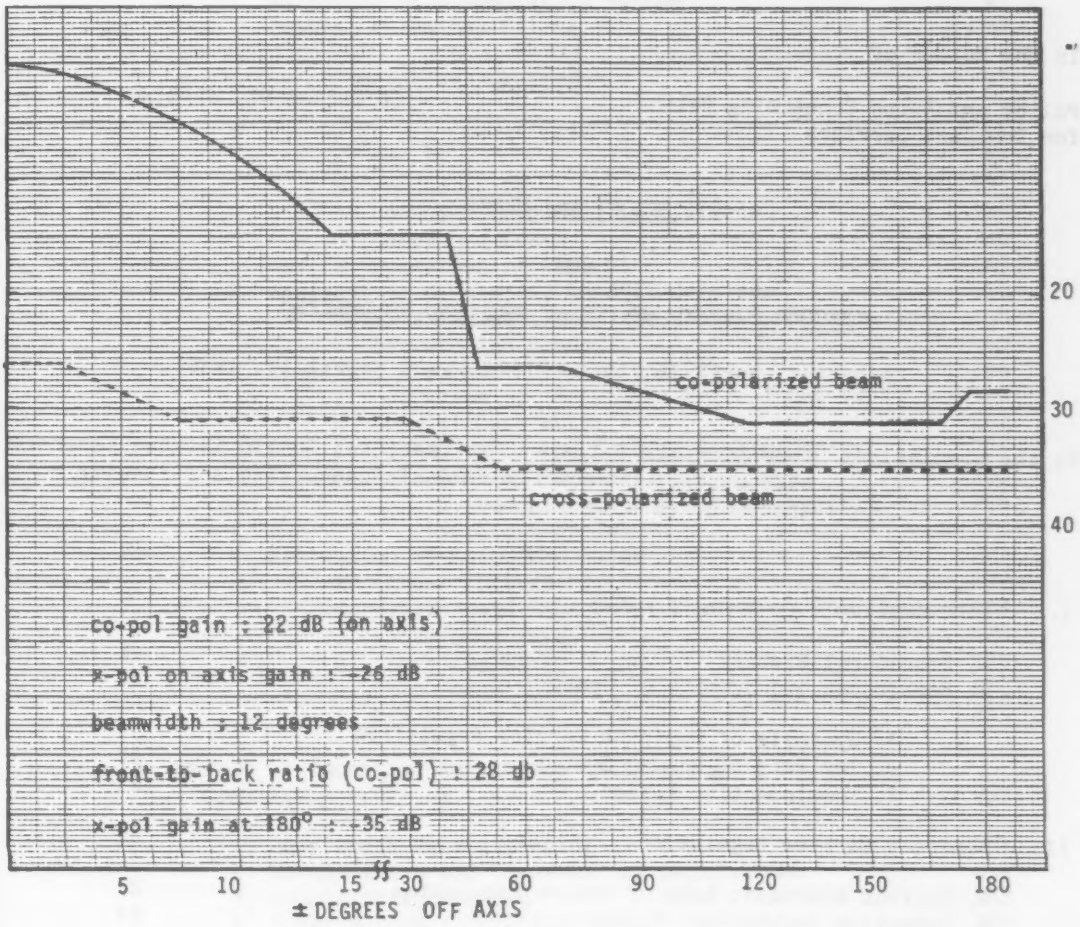


FIGURE 1: Reference Receiver Antenna Pattern

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC 89-91
37691

In the Matter of	)	
	)	
Policy and Rules Concerning Rates for Dominant Carriers	)	CC Docket No. 87-313
	)	

REPORT and ORDER

and

SECOND FURTHER NOTICE of PROPOSED RULEMAKING

Adopted: March 16, 1989 Released: April 17, 1989

By the Commission: Commissioners Patrick, Chairman; and Quello issuing separate statements; Commissioner Dennis concurring and issuing a statement at a later date.

		Page
I.	Introduction	4
	A. Procedural History	6
	B. Background and Summary of Order	10
	1. Synopsis of Dominant Carrier Regulation	10
	2. The Rate of Return System	17
	3. The Incentive System	21
II.	Dominant Carrier Regulation	27
	A. Current Approach: Rate of Return Regulation	27
	B. Incentive Regulation	41
III.	Incentive Regulation for AT&T	61
	A. Incentive Regulation as Applied to AT&T	62

1. Interaction of Competition and Regulation 62
2. Effect on AT&T Service Quality 71
3. Impact on State Regulation 85
4. Administrative Savings 91

B. Initiation of Incentive Regulation 93

1. Selection of a Regulatory System 93
2. Initial Price Cap Filing 95

C. Mechanics of Incentive Regulation 97

1. The Price Cap Index (PCI) 97
a. GNP-PI 97
b. Productivity 103
c. Consumer Productivity Dividend 125
d. Exogenous Costs 130
e. Operation of the PCI 149
2. Application of the PCI to AT&T Services 158
a. Existing Services: Inclusions and Exclusions 158
b. Baskets and Bands 165
3. Comparing Proposed Rates to the PCI 196
a. Operation of the Actual Price Index (API) 196
b. Special Case Rules 202
c. Operation of the Service Banding Index 205
d. Establishing Initial Index Values 208
i. Use of Existing Rates Generally 208
ii. Start-up Issues 217
4. Evaluation of Price Cap Rates 221
a. Annual Filings 221
b. Within-band Rate Level Changes 223
c. Above-band Rates 228
d. Above-cap Rates 235
e. Below-band Rates 239
f. New and Restructured Services 243

D. Effect of Incentive Regulation on Existing Commission Policies 257

1. Geographic Rate Averaging 257
2. Market Rules and Implementing Regulations 262
3. Complaint Procedures 263
4. Interim Cost Allocation Manual 264
5. Part 63 Rules 265
6. Part 65 Rules 265

E. Monitoring and Performance Review 266

IV. Incentive Regulation For Local Exchange Carriers 271

A. Introduction 271
B. Application of Incentive Regulation to LECs 272

1. State of Competition for LEC Services 272
2. Service Quality 278
3. Impact on State Regulation 292
4. Eligibility for the LEC Price Cap Plan 297
5. Timing of Implementation 308

C. Mechanics of Incentive Regulation for LECs 314

1. Price Cap Index 314
   a. Exogenous Costs 315
   b. GNP-PI 320
   c. LEC Productivity 321
   d. Consumer Productivity Dividend 351
   e. Operation of the PCI 352
2. Application of the PCI to LEC Services 355
   a. Service Exclusions 355
   b. Baskets and Bands 358
3. Comparing LEC Rates to the PCI and Banding Limitations 368
   a. Operation of the Actual Price Index for LECs 368
   b. Special Case Rules Regarding API Calculations 369
   c. Operation of the LEC Service Band Index 370
4. Establishing Initial Index Values 371
   a. Use of LEC Existing Rates 371
   b. LEC Start-Up Issues 377
5. Evaluation of Price Cap Rates 379
   a. Annual Filings 379
   b. Within-Band Rate Level Changes 380
   c. Above-Band Rates 382
   d. Above-Cap Rates 384
   e. Below-Band Rate Level Changes 386
   f. New and Restructured Filings 388

D. Small Company Issues 396
1. Continuation of Programs Promoting Universal Service 397
2. Geographic Rate Averaging 405

E. Other Issues 410
1. Monitoring and Performance Review 410
2. Effect of Incentive Regulation on Existing Commission Policies 413

a. ONA 413
b. Other Market Rules and Implementing Regulations 416
c. Complaint Procedures 416
d. Part 63 Rules 417

V. Legal Authority 418

VI. Paperwork Reduction Act Analysis 436

VII. Regulatory Flexibility Act Analysis 437

VIII. Ex Parte Requirements 438

IX. Ordering Clauses 439

Appendix A -- List of Parties
Appendix B -- Amendments to the Code of Federal Regulations
Appendix C -- AT&T Productivity Analysis
Appendix D -- Proposed Amendments to the Code of Federal Regulations
Appendix E -- Analysis of Industry Studies of LECs' Post-Divestiture Interstate Productivity
Appendix F -- Carrier Common Line Adjustment

I. INTRODUCTION

1. For the past two years we have been evaluating our current approach to regulating dominant carriers' rates for interstate basic service offerings to determine if our policies continue to further the objectives they originally were designed to achieve. Our current approach is based on the following theory: that limiting a dominant carrier's profit on invested capital to "normal" levels is the most effective means of restraining its market power, enhancing consumer welfare, and furthering the public interest in just, reasonable, and non-discriminatory rates. For more than twenty years we have been administering an increasingly elaborate regulatory system based on this theory. During that time circumstances in telecommunications markets have changed dramatically. Our examination of these changes and our experience administering this system lead us to conclude that our approach actually impedes, rather than facilitates, the achievement of our statutory goals with regard to the regulation of the American Telephone and Telegraph Company (AT&T) and local exchange carriers (LECs).

2. We also have been considering whether our statutory goals are more likely to be achieved by implementing an alternative regulatory approach, commonly referred to as incentive regulation. In comparison with existing regulation, this approach is more likely to help strengthen the

competitiveness of American industry in domestic and international telecommunications markets, and, most importantly, help ensure that consumers share in the benefits of the information age through lower rates and a wide array of high quality services.

3. In this Order, we find that incentive regulation represents an improvement over our existing regulation of AT&T and the LECs. We adopt rules implementing incentive regulation for AT&T on a mandatory basis. We will begin to apply those rules in May of 1989 in conjunction with our review of a tariff filing by AT&T conforming to those rules. AT&T is directed to make that filing on 45 days' notice, to be effective July 1, 1989.

4. In this Order, we also propose a plan and schedule for implementing price cap regulation for LECs. Under our proposal, price cap regulation would be mandatory for all depooled, Tier 1 LECs, and optional for all other depooled LECs. Although it may be possible to implement the proposed plan as early as January 1, 1990, it is more likely that implementation would occur in conjunction with the LECs' next annual access tariff revisions, which currently are scheduled to be filed on March 30, 1990, to be effective July 1, 1990.

5. As part of our proposal to implement a price cap system for LECs, we tentatively find it would be in the public interest to include as part of that system an additional regulatory "backstop" because we lack the same degree of corroboration for our average LEC productivity factor that we have for AT&T, and because of the possible variability of individual LEC productivity around the industry average. Our primary proposal for this backstop is a mechanism, which we refer to as an "automatic stabilizer," that would be used as part of the tariff review process to assure that LEC rates remain within a zone of reasonableness. For carriers seeking streamlined tariff review, the mechanism would force rate adjustments to provide additional assurance that all rates will fall within the zone of reasonableness and, in so doing, would provide consumers strong assurances that they will share in the benefits of LEC productivity gains achieved under price caps. We also seek comment on a potential alternative to the stabilizer, which would consist of a detailed review of the LEC price cap system initiated two years after the first LEC price cap tariffs take effect. Because the inclusion of either of these backstops into the LEC price cap plan might be perceived to be a material modification of previous proposals for incentive regulation of LECs, we are providing notice herein of our tentative decision to adopt such a backstop.

6. Our decisions in this Order do not deregulate profits or any service, or eliminate the relevance of costs to the determination of the justness or reasonableness of rates. Although some modifications to the existing regulatory structure will be required, our decisions will be implemented on a cautious basis, without wholesale changes in existing rules. The basic procedural and substantive consumer protections that exist under the current regulatory approach will be retained, and we are adding new

protections. We also will maintain existing policies and rules designed to prevent unreasonable discrimination and to promote competition. And, we are preserving existing protections for small telephone companies and their subscribers, including (1) geographic rate averaging, (2) our policy of prescribing a unitary rate of return, (3) the system of common line and traffic sensitive pools administered by the National Exchange Carrier Association (NECA), and (4) the various programs operating in conjunction with common line pooling to assist high cost companies and promote universal service.

A. Procedural History

7. This proceeding was initiated through the adoption in August 1987 of a Notice of Proposed Rulemaking (Notice).[1] In that Notice, we considered our existing approach to regulation and tentatively concluded that it is flawed from a public interest standpoint, for several reasons. Foremost among them is that current regulation does not encourage the kinds of economically efficient behavior by dominant carriers that result in cost savings, product innovations, and, ultimately, lower rates for consumers. We also determined that such an approach, which generally is known as rate of return regulation, is particularly counterproductive when applied in markets characterized by emerging competition.

8. In the Notice, we considered a different approach to regulating dominant carriers, one that presents such carriers with a more consumer-oriented set of incentives than exist under rate of return. We referred to this approach as "price caps" because its implementation entails placing limits on the rates carriers may charge for their services. In the face of such restraints, a carrier's profit level would be tied directly to its management of underlying costs and its responsiveness to consumer demand. Carriers that improved efficiency and responded to consumer demand effectively would see their profits rise. Carriers that failed to achieve these results would see their profits fall. We proposed to adjust price caps each year according to a predetermined formula that is designed to ensure a continuing nexus between tariffed rates and the underlying cost of providing service. We also demonstrated that the formula would provide carriers with an incentive to reduce their total costs and rates each year to levels lower than existing regulation could be expected to produce -- thus assuring that consumers would benefit from price cap regulation. We also sought comment on our finding that we have sufficient legal authority to impose such regulation on dominant carriers.

---

1 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987) (Notice).

9. We tentatively concluded that incentive regulation, implemented through price caps, could benefit consumers, increase efficiency, promote innovation and competition, and further the public interest more effectively than rate of return regulation, and at a lower cost to society. We sought comment on this tentative conclusion and invited interested parties to submit suggestions about the best means of designing and administering a price cap system.

10. More than 80 parties filed pleadings in response to our Notice, including consumer organizations, representatives of small and large telecommunications users, dominant and non-dominant carriers, and industry trade groups. In addition, comments were filed by a wide range of governmental entities with significant regulatory experience in the telecommunications arena, including individual state public utility commissions, the National Association of Regulatory Utility Commissioners, the United States Department of Justice, the Office of Telecommunications of the United Kingdom, and the National Telecommunications and Information Agency. These submissions consisted of more than 6,000 pages of ideas, arguments, data, and other materials that formed a sound basis for comparing, on both a theoretical and empirical basis, the strengths and weaknesses of rate of return and price cap regulation.[2]

11. With few exceptions, the record accumulated in response to the Notice reflected a broad consensus that the deficiencies of our existing system are real and warrant correction. Although many parties requested a more extensive discussion of the relative merits of such regulation and the incentive-based, price cap system proposed in the Notice, the majority of commenters agreed in principle that a price cap system could be tailored to correct the deficiencies of rate of return in connection with regulation of AT&T. Less consensus existed on the issue of applying price caps to local exchange carriers. Some commenters, for example, contended that incentive regulation cannot be applied to LECs as a matter of law and economic theory, due to the bottleneck nature of LEC provision of many interstate services. Such commenters, and others, also argued that price cap regulation could not be applied effectively to LECs for various technical reasons, such as the

---

2 A number of parties submitted specific proposals for implementing price cap regulation which differed from each other and from the framework laid out in the Notice. In order to facilitate our review of these proposals, we asked parties who had submitted such proposals to supplement their initial filings with proposed amendments to the Code of Federal Regulations that would be required to implement their plans. See FCC Public Notice, Parties in Price Cap Proceeding Requested To File Draft Rules Implementing Proposed Price Cap Plans, 3 FCC Rcd 262 (1988).

uncertainty they perceive in measuring LEC productivity, a necessary ingredient of our price cap formula.

12. We reviewed the record and presented our tentative conclusions in a Further Notice of Proposed Rulemaking adopted in May 1988 (Further Notice).[3] In that Order, we analyzed at length the strengths and weaknesses of existing regulation, incentive regulation generally, and price caps. We tentatively found that our current practices are expensive and difficult to enforce, and create incentives for carriers to pad their costs, forego efficient innovation, and cross subsidize services in ways that harm ratepayers and the competitive process. On each of these points, we compared rate of return with incentive regulation and concluded tentatively that the latter offers substantial advantages as a means of satisfying our statutory mandate to ensure just, reasonable, and non-discriminatory rates. We considered arguments that incentive regulation is unsuitable for LECs due to the lack of competitive alternatives for the services they offer, and we tentatively found such arguments unsupported in theory or by fact. Indeed, we tentatively found such arguments to be at odds with record evidence of successful administration of incentive-based regulation of LECs at the state level and in the United Kingdom.

13. In addition to articulating a detailed rationale for our tentative decision to adopt an incentive approach to regulation, the Further Notice presented a specific plan for translating incentive regulation theories into a workable regulatory system. Although some parties argued that implementation would require radical changes in existing procedures, the record also indicated that it would be possible to replace the distorted incentives created by rate of return regulation with more efficiency-oriented and consumer-oriented price cap incentives by making only modest changes in existing rules and procedures relating to the tariff review process. We tentatively decided that following the latter, more cautious approach would best serve the public interest. Therefore, we proposed to implement price caps through minimal, specific amendments to the Code of Federal Regulations, almost all of which were confined to the narrow subject of the kinds of support materials dominant carriers must file when proposing rate changes, and our treatment of such filings in the tariff review process.

14. We sought comments on our tentative conclusions contained in the Further Notice, and more than 80 parties responded.[4] These filings total

---

3 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988) (Further Notice).

4 Appendix A contains a list of the parties who filed formal comments in response to the Further Notice. This Commission also received informal comments from individual corporations who favor implementation of incentive

more than 5,000 pages of material, and comprise a substantial record in which nearly every conceivable argument for and against price caps is aired. The record also contains hundreds of pages of evidence relating to various technical aspects of our proposal, particularly those aspects concerning measurement of dominant carrier productivity. Although we review the entire record in detail in the remainder of this Order, we pause here to state two general conclusions. First, the record supports our tentative conclusion that price caps represent a regulatory approach that is superior to rate of return because price caps are better suited to encouraging efficiency and innovation in the provision of services and, thus, are better able to satisfy the goals of regulation as set forth in the Communications Act. Parties who challenge this conclusion offer no evidence in this round of comments that was not considered and rejected in the Further Notice. Second, the record accumulated in response to the Further Notice contains many suggestions about how to refine the technical aspects of our proposal to assure that price cap regulation represents a clear improvement over existing methods in terms of protecting residential ratepayers and guarding against anticompetitive actions by dominant carriers. We are persuaded that certain of these suggestions represent improvements to our initial proposal, and we modify the plan accordingly.

15. Before turning to a detailed consideration of the issues, we first provide some background on dominant carrier regulation and a summary of this Order.

---

regulation for AT&T. These corporations are: Kidder, Peabody & Co., Prudential-Bache Securities, Dayton Hudson Department Store Company, United Airlines, The Citizens and Southern Corporation, The Southland Corporation, DST Systems, and Covia Corporation. In addition to these formal and informal comments, the Florida Public Counsel filed a "Motion to Pursue Further Investigation." See Florida Public Counsel, Motion to Pursue Further Investigation, CC Docket No. 87-313, filed Sept. 28, 1988. A Motion for Further Proceedings was filed jointly by Comptel, CFA, ICA, NARUC, and MCI. See Comptel, CFA, ICA, NARUC, MCI Motion For Further Proceedings, CC Docket No. 87-313, filed Oct. 13, 1988. Six parties filed in opposition to the Motion for Further Proceedings. See AT&T Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 26, 1988; Ameritech Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 21, 1988; Bell Atlantic Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 24, 1988; Pactel Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 21, 1988; US West Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 24, 1988; USTA Opposition to Motion for Further Proceedings, CC Docket No. 87-313, filed Oct. 24, 1988. The concerns raised in the motions are addresssed in detail as part of this Order and Second Further Notice, and we are seeking further comment with respect to the LECs.

B. Background and Summary of Order

1. Synopsis of Historical Dominant Carrier Regulation

16. The Communications Act of 1934 (Act)[5] charges this Commission with regulating "so as to make available ... to all the people of the United States a rapid, efficient, Nation-wide, and world-wide ... communication service with adequate facilities at reasonable charges ...."[6] We attempt to carry out this mandate within the context of the regulatory structure established under the Act, which provides for dual regulation of telephone companies by this Commission and the individual states.[7]

17. The Act provides this Commission with various powers and tools to use in regulating the recovery of costs apportioned to the interstate jurisdiction.[8] The courts consistently have found that the Act grants us broad

---

5 47 U.S.C. §151 et seq.

6 47 U.S.C. §151.

7 47 U.S.C. § 152. Pursuant to this regulatory structure, telephone company costs are apportioned between the state and the interstate (federal) jurisdictions in accordance with rules adopted by this Commission after consultation with the states. 47 U.S.C. §§ 221(c), 410(c). Such costs are thereafter recovered according to applicable federal or state regulatory policies. The apportionment process is commonly referred to as "jurisdictional separations," and the procedures governing apportionments are incorporated into Part 36 of this Commission's rules. See 47 C.F.R. § 36.1 et seq. These rules cannot be changed unilaterally. Rather, proceedings regarding apportionments must be referred to a Federal-State Joint Board comprised of four state commissioners appointed by the National Association of Regulatory Utility Commissioners and three federal commissioners appointed by the Chairman of this Commission. 47 U.S.C. § 410(c). The Joint Board makes recommendations for this Commission's consideration. Id. No changes in jurisdictional apportionments are adopted or proposed in the instant proceeding. At the present time, approximately 84.6 percent of AT&T's total company non-access costs, and approximately 30 percent of LEC regulated costs, are apportioned to the interstate jurisdiction.

8 Title II of the Act contains provisions granting this Commission the powers commonly associated with public utility regulation. These powers include the authority to require a carrier to interconnect with other carriers and to establish through routes, 47 U.S.C. § 201(a), to determine whether carriers' rates and conditions of service are just and reasonable, 47 U.S.C. § 201(b), and without unreasonable preferences or discriminations, 47 U.S.C. § 202(a). Section 203 authorizes this Commission to determine the information

discretion to employ these tools in a flexible manner, in accordance with prevailing circumstances and conditions.[9] With regard to the ratemaking process, the courts have determined that there is no single method or formula that agencies must use to satisfy the requirements in Title II of the Act and other similar statutes that rates be just and reasonable, and not unreasonably discriminatory. Instead, courts evaluate the end result of particular regulatory methodologies to determine whether they produce rates that fall within a "zone of reasonableness," an area bounded at the lower end by investor interests in maintaining financial integrity and access to capital

---

that must accompany carriers' tariff filings, while Section 204 of the Act empowers this Commission to suspend and investigate proposed rates on our own initiative or in response to a petitioner's request. 47 U.S.C. §§ 203, 204. Should investigation establish the unlawfulness of rates, this Commission may prescribe just and reasonable terms to replace the offending conditions. 47 U.S.C. § 205. Section 214 enables this Commission to control entry into and exit from the interstate market and to control to some extent a carrier's expansion of its rate base. 47 U.S.C. § 214. Title II also permits this Commission, inter alia: to determine the value of the property a carrier includes in its rate base, 47 U.S.C. § 213; to prescribe depreciation rates as well as accounting systems to be used by carriers subject to the Act, 47 U.S.C. § 220; and to require such carriers to file any additional information this Commission may need to fulfill its statutory mandate, 47 U.S.C. §§ 213(f), 218, 219. The Act also contains more generalized grants of authority to regulate. For example, under Section 4(i), this Commission "may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with [the Act], as may be necessary in the execution of its functions," while Section 4(j) permits this Commission to "conduct its proceedings in such manner as will best conduce to the proper dispatch of business and to the ends of justice." 47 U.S.C. §§ 154(i), 154(j). Section 201(b) of the Act authorizes this Commission to "prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this [Act]." 47 U.S.C. § 201(b).

9 The Supreme Court, for example, has determined that the dynamic and rapidly changing nature of the communications industry requires "that the administrative process possess sufficient flexibility to adjust itself to these factors." FCC v. Pottsville Broadcasting, 309 U.S. 134, 138 (1940). See also United States v. Southwestern Cable, 392 U.S. 157 (1968); National Broadcasting v. United States, 319 U.S. 190 (1943). Indeed, "regulatory practices and policies that will serve the public interest today may be quite different from those that were adequate for that purpose in 1910, 1927 or 1945 ...." Washington Util. & Transp. Comm'n v. FCC, 512 F.2d 1142, 1157 (9th Cir.), cert. denied, 423 U.S. 836 (1975).

markets and at the upper end by consumer interests against non-exploitative rates.[10]

18. Since this Commission was created in 1934, we have revisited and altered the mix of our regulatory policies and rules on many occasions. At the present time, we employ a regulatory system known as rate base, or rate of return, regulation to ensure that the rates for AT&T and LEC interstate services remain within the zone of reasonableness. This approach requires not only that we establish a carrier's allowable rate of return, but also whether: (1) its investment and cash expenses are properly calculated and efficiently incurred; (2) the level of non-cash expenses such as depreciation and other accruals is properly reflected in rate calculations; and (3) the rates proposed or in effect cover these costs and produce a fair rate of return.[11]

19. This elaborate approach is often thought of as "traditional" regulation. In fact, we did not begin to develop this system until the mid-1960s. Prior to that time, there were no explicit criteria for determining whether Bell System rates were just and reasonable. Instead, we followed a policy of "continuing surveillance" of Bell System earnings levels to ensure that rates remained within the zone of reasonableness. This process operated without regular formal proceedings of any kind, and rate adjustments occurred only if this Commission or Bell System representatives initiated "discussions looking toward appropriate rate changes whenever the level of ... total interstate earnings ... appeared to warrant such action."[12]

20. During the period when the "continuing surveillance" policy was in effect, a voice occasionally was raised in complaint that the Bell System's costs and rates might be too high,[13] but only once during this period did

---

10 Jersey Central Power & Light v. FERC, 810 F.2d at 1177-78; see also FERC v. Pennzoil Producing, 439 U.S. at 517 (to fall within the zone of reasonableness, rates must be neither "less than compensatory" nor "excessive"); AT&T Information Systems v. FCC, No. 85-1198, slip op. at 3 (D.C. Cir. Aug. 30, 1988)(for rates to be just and reasonable "there must be 'a balancing of the investor and consumer interests...'").

11 For a more detailed description of the activities associated with administering rate of return regulation, see the Notice, 2 FCC Rcd at 5209-10.

12 Am. Tel. & Tel Co., Docket No. 16258, 2 FCC 2d 173, 177 (1965).

13 See, e.g., Western Union Telephone Co., 17 FCC 152, 175 (1952) (Commissioner Hyde, dissenting)(Commission decision sustaining Bell System tariff restrictions precluding interconnection with alternative video service transmission provider close off opportunity to test whether Bell System costs and rates are artificially high).

this Commission initiate a comprehensive investigation of such matters. This inquiry in the late 1930s cost millions of dollars and occupied approximately 300 researchers for several years. The staff's efforts culminated in the preparation of a voluminous report on Bell System costs and operations, but allegations of inflated costs and rates -- and substantial cost shifting between unregulated Western Electric and regulated telephone company operations -- were never documented to the Commission's satisfaction. Ultimately, no action was taken on the report's major recommendations, and the investigation produced no significant changes in Commission or Bell System procedures.[14]

21. The use of "continuing surveillance" to assure just and reasonable rates occurred during a period when the Bell System faced little or no competition in the domestic interstate telecommunications market. The absence of competition resulted in large measure from the formidable barriers to entry into telephone markets, including substantial scale economies that operated to the advantage of the incumbent Bell System. These barriers may not have been so great as to impart to the telephone industry the status of a "natural monopoly," but they formed a distinct boundary between that industry and other industries. And, they existed during a time of technological stability.

22. In the 1950s and 1960s, technological developments began to lower economic barriers to entry into the telephone business and to put pressure on the boundary between telephone companies and other firms. The development of microwave technology rendered scale economies insignificant at the "high" end of the telephone market. As a result, entities using large amounts of telephone service, which generally had been telephone company customers, could operate their own telephone systems and, potentially, compete against their former suppliers. The development of satellite technology as a cost-effective method of transmitting messages transformed firms with satellite expertise into potential entrants into the telephone field. Previously unrelated firms, such as aerospace companies and the Bell System, thus came into competitive interaction. Rapid development of digital electronics and transistor technology blurred the line between computers and communications. Computer systems took on the characteristics of telephone systems -- i.e., switches linked by transmission lines -- while, at the same time, telephone companies were adopting computer technology for use in communications systems and expanding their operations into the domain of computer firms.

23. This Commission was not unmindful of the pressures and changes generated by technological developments. In the face of such developments,

---

14 See FCC, Investigation of the Telephone Industry in the United States (1939)(Walker Report)(Arno Press ed. 1974); see generally G. Brock, The Telecommunications Industry: The Dynamics of Market Structure 179-80 (1981).

and often following the lead of the courts,[15] we embarked on two paths of regulatory change.

24. The first path consisted of a series of proceedings in which we addressed the impact of technological advances that made it possible for companies outside the Bell System to provide telecommunications equipment and services. The second path consisted of a series of proceedings in which we abandoned the "continuing surveillance" policy and began to construct the regulatory system currently relied upon to regulate dominant carriers. In retrospect, it is easy to see how the two paths of regulatory change were related in major part, with the second coming as a response to the first. Permitting entry into certain segments of telecommunications allowed competition to develop in part, but not all, of that market. New competitors called upon this Commission to police the boundary between the competitive and less competitive portions of the market, and to arbitrate disputes among all competitors. Issues that had been left largely to telephone companies during the period of "continuing surveillance," such as rate structure, became crucial competitive variables. The allocation of telephone company costs among competitive and less competitive services became a subject of intense controversy.

25. With regard to both paths, this Commission's efforts were devoted to structuring regulatory policies that affirmatively promote competition, that rely on competitive forces as an effective means of assisting us in achieving our statutory goals, or that attempt to emulate the operations of a competitive market. The public interest rationale for applying this competition-based regulatory model is readily understandable. Companies subject to competition are forced to operate in ways that generally result in just, reasonable, and non-discriminatory rates. Although firms operating in a competitive environment simply are attempting to maximize their profits, the various means each uses to achieve this result -- innovating, enhancing efficiency, providing quality services -- benefit consumers individually and society as a whole.[16]

---

15 For example, the courts paved the way for competition's growth in the interstate MTS and WATS markets. See MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1978), cert. denied, 434 U.S. 1040 (1978) (Execunet I) (Section 241 of the Act required affirmative determination that public interest, convenience and necessity mandated restricting MCI to provision of private line service); MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir.), cert. denied, 439 U.S. 980 (1978) (Execunet II) (AT&T required to provide interconnections for MCI's Execunet services).

16 We recognize, of course, that the competitive model may not be sufficient by itself to achieve all the objectives established in the Act. For example, we have construed our mandate under the Act to include the promotion of universal service. See, e.g., Notice, 2 FCC Rcd at 5209 (para.

26. Commission proceedings directed toward affirmatively promoting competition in telecommunications markets yielded clear and substantial public interest benefits. For example, decisions to deregulate the provision of customer premises equipment (CPE) resulted in greatly increased consumer choice among a wide range of such products, and a sharp decrease in prices.[17] Likewise, after we opened entry into the market for interstate long distance services, and determined that the lack of market power among most new entrants made it unnecessary to regulate their operations comprehensively, the prices

---

4). Achieving this goal requires us on occasion to exercise our powers under Titles I and II in ways that do not conform to a competitive paradigm. Thus, in order to promote universal service among low income households and telephone subscribers in high cost study areas, including rural subscribers, we designed and implemented Lifeline and High Cost Assistance programs. See MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72, 80-286, 2 FCC Rcd 2953, 2955-56 (1987). We also have acted on many occassions to preserve the policy of geographic rate averaging, most recently by modifying the common line pooling process. See id. at 2956-57. Nothing in the price cap plan we adopt for AT&T or propose for the LECs undermines our ongoing commitment to universal service.

17 In a series of proceedings spanning almost two decades, we determined that customer premises equipment (CPE) and "enhanced services" were not common carrier services subject to Title II regulation and could be provided on a fully competitive basis. We ceased regulating the provision of CPE except for rules governing technical interconnection standards, and regulation of enhanced services was restricted to stipulating the conditions for dominant carrier participation in markets for such services. See Regulatory and Policy Problems Presented by the Interdependence of Computer and Communications Services and Facilities, Tentative Decision, 28 FCC 2d 291 (1970); Final Decision and Order, 28 FCC 2d 267 (1971) (Computer Inquiry), aff'd on recon. 34 FCC 2d 557 (1972), aff'd in principal part sub nom., GTE Service Corp. v. FCC, 474 F.2d 724 (2nd Cir. 1973); on remand 40 FCC 2d 293 (1973); Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry, Computer II), Final Decision, 77 FCC 2d 384, modified on recon. 84 FCC 2d 50 (1980), modified on further recon. 88 FCC 2d 512 (1981), aff'd sub nom. Computer and Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982), cert. denied sub nom. Louisiana Pub. Serv. Comm'n v. United States, 461 U.S. 938 (1983), aff'd on second further recon. FCC 84-190, released May 4, 1984; Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry, Computer III), Report and Order, 104 FCC 2d 958 (1986), clarified on recon. 2 FCC Rcd 3035 (1987).

for such services fell and the number of service providers grew exponentially.[18]

27. This Commission did not achieve similarly clear-cut and uniform benefits in connection with proceedings devoted to applying detailed rate of return regulation to the Bell System and its progeny after divestiture. Some unqualified successes were achieved. For example, certain market rules adopted in these proceedings -- such as those prohibiting tariff restrictions on the resale or sharing of domestic public switched network services,[19] and those requiring dominant carriers to provide Open Network Architecture and Comparably Efficient Interconnection to enhanced service providers[20] -- help assure that dominant carriers structure their rates in a just, reasonable, and non-discriminatory fashion.

28. Other proceedings, however, have not yielded the same sort of tangibly positive results. For example, in response to concerns that the Bell System might be using revenues from MTS/WATS to subsidize its private line services, which at that time were just beginning to confront the threat of competition from private microwave systems, we reconsidered our policy of continuing surveillance and initiated an investigation of the Bell System that ultimately led to our first prescription of a rate of return for its interstate operations.[21] Throughout most of the 1970s, we conducted

---

18 These proceedings began in 1959 in connection with the licensing of private microwave facilities. See Allocation of Microwave Frequencies Above 890 Mc., 27 FCC 359 (1959). Thereafter, this Commission authorized limited competition in the so-called private line market. See Specialized Common Carrier Services, 29 FCC 2d 870 (1971), aff'd sub nom., Washington Util. & Transp. Comm'n v. FCC, 513 F.2d 1142 (5th Cir.), cert. denied, 423 U.S. 836 (1975). After entry into the MTS and WATS market was opened, this Commission developed a policy of classifying common carriers as dominant or non-dominant, in accordance with determinations of their market power. The purpose of these proceedings, generally known as the Competitive Carrier proceedings, was to adjust rate filing and facilities review procedures to reflect changes in the telecommunications marketplace. For a detailed description of these proceedings, see the Notice, 2 FCC Rcd at 5209, and the Further Notice, 2 FCC Rcd at 3201-02.

19 See Regulatory Policies Concerning Resale and Shared Used of Common Carrier Domestic Public Switched Network Services, 83 FCC 2d 167 (1980), recon. denied, 86 FCC 2d 820 (1981).

20 See Filing and Review of Open Network Architecture Plans, 4 FCC Rcd 1 (1988).

21 See Am. Tel. and Tel. Co., 2 FCC 2d 173 (1965) (investigation initiated); Am. Tel. and Tel. Co., 9 FCC 2d 30 (1967) (Commission prescribed

extensive and complex investigations of the Bell System's rate base and cost allocation systems, and of its tariffed rates.[22] In a repeat of our rate base investigation in the 1930s, no significant disallowances of carrier investment resulted from these inquiries.

2. The Rate of Return System

29. Our experiences in travelling the second path of regulatory change, in which we developed the existing rate of return structure, illuminate the difficulties of administering rate of return regulation under any circumstances. In theory, rate of return is intended to replicate competitive market results. However, there are many differences in the manner in which rate of return regulation and competitive forces operate. Competition holds each firm to "normal" profit levels as a result of a dynamic process that operates over time -- a firm strives to maximize profits and secure advantage over other firms by responding to consumer demand effectively. Under rate of return, however, "normal" profit levels are established in advance by regulatory fiat. The dynamic process that produces socially beneficial results in a competitive environment is strongly suppressed. In fact, rather than encourage socially beneficial behavior by the regulated firm, rate of return actually discourages it.

30. The distorted incentives created by rate of return regulation are easily illustrated. In a competitive environment, where prices are dictated by the market, a company's unit costs and profits generally are related inversely. If one goes up, the other goes down. Rate of return regulation stands this relationship on its head. Although carriers subject to such

---

rate of return for interstate operations of Bell System); Am. Tel. and Tel. Co., 18 FCC 2d 761 (1969) (proceeding initiated to establish general ratemaking principles for Bell System).

22 The proceeding initiated in 1969 to establish ratemaking principles for the Bell System was folded into an investigation of AT&T tariff rates. See AT&T Long Lines Department, Revisions to Tariff F.C.C. No. 260, Private Line Services, Series 5000 (Telpak), Docket No. 18128, 61 FCC 2d 587 (1976), recon., 64 FCC 2d 971 (1977), further recon., 67 FCC 2d 1441 (1978), aff'd in pertinent part sub nom., Aeronautical Radio v. FCC, 642 F.2d 1221 (D.C. Cir. 1980) (Telpak). The Telpak proceedings led this Commission to conclude that allocations based on historical cost causation were, in theory, most desirable. This Commission, however, never succeeded in using its preferred methodology to determine lawful rates for Bell System services. See AT&T, Manual and Procedures for Allocation of Costs, 84 FCC 2d 667 (1981) (ICAM Proceeding), aff'd sub nom. MCI Telecommunications Corp. v. FCC, 675 F.2d 408 (D.C. Cir. 1982).

regulation are limited to earning a particular percentage return on investment during a fixed period, a carrier seeking to increase its dollar earnings often can do so merely by increasing its aggregate investment. In other words, under a rate of return regime, profits (i.e., dollar earnings) can go up when investment goes up. This creates a powerful incentive for carriers to "pad" their costs, regardless of whether additional investment is necessary or efficient. And, because a carrier's operating expenses generally are recovered from ratepayers on a dollar-for-dollar basis, and do not affect shareholder profits, management has little incentive to conserve on such expenses. This creates an additional incentive to operate inefficiently. Moreover, in situations in which carriers providing more than one service face competition for one or more of such services, rate of return regulation enables carriers to distort the competitive process by manipulating their reported cost allocations.

31. A system that establishes such incentives is unlikely to encourage efficiency. Moreover, administering rate of return regulation in order to counteract these incentives is a difficult and complex process, even when done correctly and well. This is so primarily for two reasons. First, such regulation is built on the premise that a regulator can determine accurately what costs are necessary to deliver service. In practice, however, a regulator may have difficulty obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs. Furthermore, no regulator has the resources to review in detail the thousands of individual business judgments a carrier makes before it decides, for example, to install a new switching system.

32. The second inherent difficulty associated with administering rate of return regulation relates to its requirement that determinations be made about how to allocate a carrier's costs among services that often are provided jointly or in common. Such determinations tend to become more economically problematic as they become more detailed. The history of this Commission's experience in this area over the past several decades reflects the difficulty of implementing cost allocation systems.[23] We recently have been able to implement rational and effective allocation systems for the purpose of allocating costs between regulated and nonregulated activities.[24] It must be recognized, however, that even though cost allocation systems deter anticompetitive activity and assist in its detection, these results may be obtained at a high cost to society. This is so because a cost allocation

---

23 See, e.g., AT&T, Charges for Interstate Telephone Services, Docket No. 19129 (Phase II), 64 FCC 2d 1 (1977).

24 See Separation of Regulated from Nonregulated Costs, 2 FCC Rcd 1298 (1987); Further Notice, 2 FCC Rcd at 3225-26 and notes therein.

system can present a strong deterrent to anticompetitive activity and, at the same time, be so detailed and rigid that it imposes on a carrier a complex and inflexible rate structure, one that may have little relation to consumer demand. If such a rate structure is deployed in a competitive environment, it may result in distorted consumption decisions, distorted production decisions, and distortions of the competitive process.

33. Our experiences administering rate of return regulation lead us to conclude that this methodology has certain inherent flaws. As explained above, this type of regulation presents carriers with certain incentives -- to pad their rates and forgo efficient innovation, for example -- that are perverse when viewed from a public interest perspective. These incentives would exist even if technology and industry boundaries were to remain stable, and the existence of such incentives alone provides sufficient justification to seek alternative regulatory approaches that are better suited than rate of return to achieving the consumer-oriented goals of the Communications Act.

34. We have every reason to expect, moreover, that the telecommunications industry will continue to be marked in the future by the same steady technological advancement it has demonstrated in the past. This will lead to greater competition than at present and a continuing shift in the boundaries between the competitive and less competitive segments of the telecommunications marketplace. Notwithstanding this technological change and growing competition, we could continue our current practice of implementing cost allocation systems that present strong deterrents to anticompetitive activity associated with those boundaries, but it will become increasingly difficult to obtain these benefits while concomitantly holding to a minimum the costs such deterrents impose on society. We conclude, therefore, that it is prudent to implement regulatory systems that are better able than rate of return to operate effectively in an environment marked by competition and technological change.[25]

---

25 It is important to note that the difficulties of policing the shifting boundaries of the telecommunications industry are not eliminated even by very strong attempts to establish regulatory boundaries, such as by establishing structural conditions on market entry or restricting market entry altogether. For example, divestiture was an attempt to draw a very distinct boundary between more and less competitive telecommunications services. The basic theory of the antitrust case which resulted in the divestiture was that the local exchange constituted a bottle-neck that provided a base from which monopoly power could be extended to the adjacent long distance market. By separating local exchange from interstate toll operations, it was thought that competition could flourish in the potentially competitive latter segment of market, and all competitors could draw on the services of carriers operating in the former segment of the market. United States v. Western Electric, 569 F. Supp. 990 (1983). The boundary drawn between what was thought to be the "bottleneck" and the more competitive portions of the Bell

35. Our concerns about rate of return regulation are shared by many state, federal, and foreign bodies with experience in the telecommunications arena. The National Telecommunications and Information Agency (NTIA) has evaluated the rate of return approach and found it wanting in many respects.[26] Both NTIA and the United States Department of Justice are participating in this proceeding, and both are supportive of the price cap approach, particularly as we have proposed to apply it to AT&T.[27] Regulators in the United Kingdom have administered price cap regulation successfully since 1984.[28] Furthermore, the flight from the rate of return approach by state regulators continues unabated. Only 20 of the 42 states in which AT&T offers service currently regulate AT&T pursuant to a regulatory structure like that

---

System, however, has proven to be far less precise than originally supposed. Competition is beginning to take root in a few segments of the local exchange market, particularly regarding the provision of services to the high end of that market (e.g., provision of DS-3 lines to large users of telecommunications services). See Local Exchange Carriers' Individual Case Basis DS3 Service Offerings, 3 FCC Rcd 2582 (1988); Supplemental Order Designating Issues for Investigation, 3 FCC Rcd 6066 (1988). AT&T, moreover, retains significant market power in portions of the long distance market (e.g., 800 Service; international). Provision of Access for 800 Service, CC Docket No. 86-10, Supplemental Notice of Proposed Rulemaking, 3 FCC Rcd 721 (1988); Regulatory Policies and International Telecommunications, CC Docket No. 86-494, Report and Order and Supplemental Notice of Inquiry, FCC 88-71, released Mar. 25, 1988. We do not intend here to question the wisdom of divestiture. We wish merely to illustrate that technological change, and the competitive opportunities that flow from it, often transcend even the strongest structural attempts of regulators to impose very clear industry boundaries, and that such attempts provide only limited and often temporary solutions to the shifting boundary dilemma. This reinforces our belief that it is prudent to adopt regulatory approaches that are strong enough to police the boundary line effectively, yet flexible enough to accommodate technological and competitive advances that cannot be predicted with precision by regulators.

26 NTIA, Regulatory Alternatives Report (1987), filed as NTIA Comments in CC Docket No. 87-313, Oct. 26, 1987.

27 See id.; Reply Comments of the U.S. Department of Justice, CC Docket No. 87-313, filed Dec. 14, 1987.

28 See Office of Telecommunications Statement, "The Control of British Telecom's Prices," released July 7, 1988 (setting forth a plan to continue price cap regulation until 1993).

employed by this Commission, and the number of states applying some form of incentive regulation to LECs is increasing.[29]

3. The Incentive System

36. The attractiveness of incentive regulation lies in its ability to replicate more accurately than rate of return the dynamic, consumer-oriented process that characterizes a competitive market. In general, such regulation operates by placing limits on the rates carriers may charge for services. In the face of such constraints, a carrier's primary means of increasing earnings are to enhance its efficiency and innovate in the provision of service. Because cost padding and cross-subsidization do not justify higher prices under this system -- but instead lower profits -- the incentives to engage in such activity are limited. The system also is less complex than rate of return regulation and easier to administer in the long run, which should reduce the cost of regulation.

37. Because cost allocation requirements do not play as central a role under incentive regulation as they do under rate of return, incentive regulation represents a more effective method of policing shifting industry boundaries than rate of return. The restraints on price increases become less significant when competition develops because competitive forces hold prices down. Indeed, a system of pricing restraints offers a means of determining what sectors of the market are becoming competitive, as this will be revealed when carriers voluntarily price below authorized pricing levels. Our ability to obtain such information will enable us to determine more accurately under incentive regulation than we can under rate of return what, if any, further movement should be made regarding regulation of particular dominant carriers. More important, the pricing limitations offer consumers strong protection against attempted exercises of market power.

38. The incentive regulatory approach adopted for tariff review purposes in this Order for AT&T and proposed for the LECs operates according to the following model. A carrier's services are grouped together in accordance with common characteristics, and the weighted prices in each group are adjusted annually pursuant to formulas designed to ensure that rates are based on the cost of providing service. The formulas provide for adjustments similar to those carriers make to their rates under the current system. For example, all carriers currently adjust their rates in accordance with changes in their input costs. Our formulas accomplish the same result, measuring such changes with reference to the Gross National Product Price Index (GNP-PI), a recognized, government-administered index that reflects broad-based input cost changes experienced by dominant carriers more accurately than the more

---

29 See Section II. B, infra, discussing regulatory reform for AT&T and the LECs at the state level.

commonly known Consumer Price Index. We also will continue under price caps the current policy of adjusting rates for known cost changes, such as those caused by regulatory decisions, that are beyond a carrier's direct control. For example, AT&T's rates will be adjusted to reflect regulatory changes, such as changes in the level of access charges, as is the case today.

39. Our incentive system also requires that we add another component to our formula limiting aggregate price increases. Although the GNP-PI already reflects productivity gains for the economy as a whole, it does not reflect the degree of productivity gains experienced by the telecommunications industry historically. A number of studies demonstrate that the telecommunications sector has been more productive than the economy as a whole. In evaluating how large to make the productivity factor, we have examined a number of long term historical studies of pre-divestiture Bell System productivity and concluded that, on a long term basis, productivity has been approximately 2.1 percent per year higher than the general economy. Data from the more recent period, i.e., the 1970s and 1980s, have tended to be slightly higher than the number suggested by the long term studies. Our own analysis of AT&T's price changes during the post-divestiture period indicates that AT&T's productivity differential since 1984 has been approximately 2.3 percent per year. Because we are sufficiently impressed with evidence of the more recent trend in telecommunication productivity indicating a productivity level slightly above the long term view, and because we wish to err, if we must, on the side of consumers, we have decided that AT&T's productivity factor under our plan should be 2.5 percent per year.

40. For the LECs, we similarly found that the available data suggest a long term historical productivity differential of slightly over 2 percent per year above the general economy, with a slightly higher differential in the more recent period. Unlike for AT&T, however, we are unable to corroborate to the same degree the LECs' productivity experience since divestiture. Because of this and possible variations in individual LEC productivity around the industry average, we tentatively have decided to proceed with a 2.5 percent productivity factor, while proposing other adjustments to LEC aggregate prices in order to ensure just and reasonable rate levels.

41. The downward pressure on rates exerted by the 2.5 percent productivity offset assures that consumers will be as well off under caps as they likely would have been under rate of return. Because our goal is to make consumers better off under price caps than they likely would be if we continued rate of return regulation, however, our plan requires carriers to meet goals that exceed the historic productivity of the telephone industry. In addition to the 2.5 percent adjustment noted above, carriers would be required to lower rates by another 0.5 percent -- an amount we refer to as the Consumer Productivity Dividend -- in order to ensure that consumers receive a guaranteed, up-front share of the additional efficiencies flowing from the improved incentives created by price cap regulation.

42. In effect, the price cap rate adjustment formula establishes a rule of thumb to use in evaluating a carrier's performance for tariff review purposes: a benchmark. The rates filed by carriers are self-initiated, but the relationship of those filed rates to the price cap formula will trigger various types and levels of Commission scrutiny. If a carrier achieves results superior to this benchmark as a result of its own initiative, it is permitted to keep the resulting profits, at least for a while. If a carrier claims that it cannot achieve the benchmark, we will suspend its tariff revisions and examine its proferred justification. Suspension and investigation is a reasonable response to such an event because the benchmark is based in part on a measurement of carriers' past performance, calculated on a long run basis, and failure to achieve that level of performance is legitimate grounds for inquiry. After the fourth year of the plan, the mark is subject to adjustment as a result of our comprehensive review of the price cap system, which will be conducted in light of the information the carrier reveals about itself in the course of operating pursuant to the plan. This ensures that consumers will be the beneficiaries of all achieved efficiencies. And, this Comission will monitor carriers' performance throughout the four-year period to ensure that the system is operating in the public interest and will make adjustments as necessary. Moreover, Section 204 investigations and Section 208 complaint proceedings will continue to be a forum for examining cost and profit data, as appropriate.

43. In addition to lower rates, consumers will receive other benefits as a result of incentive regulation implemented through price caps. First, for example, they will receive assurances of rate stability that do not exist under existing regulation. These assurances result from banding limitations that mark the boundaries of potential annual price changes that would be permitted without triggering detailed investigation through the tariff process. Second, price cap regulation should spur innovations that result in consumers enjoying a wider range of high quality services at cost-effective prices. This spur to innovation should occur because, quite simply, carriers operating under price caps can make more money in the short term than under existing regulation if they respond to consumer demand for more and better services. And these are just the direct consumer benefits. The incentives for greater efficiency and innovation established by price caps should provide indirect benefits for society as a whole. Increased productivity will make the telecommunications industry more competitive both at home and abroad. In addition, a system that promotes efficiency and innovation has the indirect effect of lowering the cost of non-telecommunications goods and services because telecommunications services are a significant and growing input of the economy generally.

44. In general, caps will be applied to all of a carrier's existing services. Such application ensures that price cap regulation provides the greatest amount of consumer benefit and protection. Existing rates have been subject to the tariff review process, often involving exacting scrutiny, and represent the best and most practical place to initiate the new system. Although some existing rates currently are under investigation, this presents

no legal barrier to their use in initiating price cap regulation. The Communications Act specifically contemplates that rates subject to investigation shall take effect, and this has occurred on many occasions during this Commission's history.[30] Investigations will continue to be initiated and resolved under price cap regulation, as appropriate, just as they are today under rate of return regulation. Nothing in the price cap plan prevents us from ordering adjustments, including refunds, in the event that a rate subject to investigation is found to be unlawful after the initiation of price cap regulation and we fully intend to exercise our authority in such instances.

45. Implementing price cap regulation primarily through the tariffing process eliminates any need to make wholesale revisions in our existing rules. Our plan presents no threat to policies and programs designed to benefit low-income households or rural America, such as the Link-Up America program and geographically averaged long distance rates. In order to ensure that our proposal does not disturb telecommunications regulation by the states, no changes to jurisdictional separations rules or procedures have been proposed.

46. The plan we adopt today for AT&T, and our proposal for regulating LECs through price caps, are structured to ensure the continuation of the high quality telephone service Americans currently enjoy. All existing Commission procedures and reporting requirements relating to the monitoring of service quality are retained, and our LEC proposal outlines and seeks additional comment on methods of strengthening these procedures and reporting requirements.

47. It is important to note as a general matter that many forces constrain a carrier's ability to degrade its quality of service. First, cutting back on quality does not necessarily increase profits because permitting the network to deteriorate would result in larger blocking percentages, poorer transmission clarity, and longer down-time for switches and lines -- all of which ultimately reduce the number of completed calls and, therefore, a carrier's revenues. A second practical restraint is that quality declines manifest themselves readily. No customer needs special training to detect an increase in busy signals, wrong numbers, or static on the line. And as this Commission demonstrated in the post-divestiture period when such complaints were made, we can respond swiftly and effectively to

---

30 The Act provides that this Commission may require carriers to give up to 90 days' notice of proposed revisions to their tariff rates. 47 U.S.C. § 203(b). The Act also provides that the Commission may suspend the effective date of such filings for up to five months for purposes of investigating the lawfulness of such filings. 47 U.S.C. § 204(a). "If the...(investigation) has not been concluded and an order made within the period of suspension,...(the) charge...shall go into effect...." Id.

customer complaints about quality. A third restraint is that competition in the long distance market has turned quality into an important selling point, indicating that AT&T could permit quality to decline only at peril to its market position. We conclude that the combination of these practical restraints, and our ongoing monitoring efforts, will ensure that quality of service does not decline under price cap regulation.

48. Our price cap plan does not disturb this Commission's commitment to fostering competition and preventing discrimination in the provision of telecommunications services. Over the years, we have demonstrated this commitment by implementing such policies as open entry, equal access, resale and shared use, freedom of interconnection, the unbundling of tariffed services, and the non-structural safeguards under development in our Computer III and Joint Cost rulemakings. These policies will be continued under price cap regulation, and we shall continue to enforce them vigorously.

49. The price cap plan we adopt today for AT&T is very similar to the one proposed in the Further Notice. In response to the record, however, we have altered the combination of baskets and bands used to constrain AT&T price adjustments in order to strengthen protections against predatory pricing and to provide residential consumers greater assurances of lower rates in the future.

50. As adopted in this Order, AT&T services used primarily by residential customers are placed in their own basket. Separating such services in this manner ensures that residential customers will receive a larger proportion of expected AT&T future productivity achievements than would be guaranteed under the proposal in the Further Notice or under existing regulation.

51. We also have grouped AT&T's remaining services into two baskets, according to an evaluation of the degree of competition AT&T faces in the provision of such services. All of these services are targeted primarily toward business customers. The record reflects a consensus that AT&T faces varying degrees of competition for such services, and that they should be separated accordingly. We are persuaded by this record showing and, consequently, we have created a separate basket for 800 services, in which AT&T retains substantial market power. All other AT&T business services -- those provided in what the majority of commenters agree is the most competitive segment of the telecommunication market -- are grouped together in what constitutes the third "service basket" contained in our plan. Grouping services in this fashion provides greater assurances than exist under existing regulation or the plan proposed in the Further Notice that AT&T will not raise prices for services for which it retains substantial market power and use revenues generated thereby to fund price decreases for other, more competitive services.

52. Because these changes in the structure of the baskets in our price cap plan significantly reduce AT&T's ability to shift costs among its various

services, they also enable us to place upper and lower banding limitations on service categories, as opposed to the rate-element-by-rate-element approach proposed in the Further Notice. The upper band constitutes a service category price ceiling which AT&T must establish substantial cause to pierce. The lower band constitutes a price "floor." AT&T may propose service category rate decreases lower than 5 percent, but such a proposal must be accompanied by cost materials demonstrating that the proposed reduction is not predatory.

53. The plan proposed in the Further Notice for applying price cap regulation to the LECs was identical to the plan proposed for AT&T in most respects, and the LEC proposal generated the largest and most critical response to the Further Notice. This is not surprising. As we stated in the initial Notice, applying price cap regulation to LECs raises difficult and complex issues. This is not because of any weakness in the theory of incentive regulation as it is applied to the LECs. Rather, such difficulties arise in the context of implementation.

54. We are not persuaded by arguments that price caps cannot be applied to the LECs because implementing this alternative regulatory system entails making predictions. If a need to make predictions were a basis for finding a regulatory process fatally flawed, we would have to abandon rate of return immediately because it is based almost entirely upon predictions. As noted previously, under rate of return regulation this Commission is required to make predictions almost on a daily basis about all aspects of dominant carrier operations, from their construction proposals to the estimates of future costs and demand that form the basis for carriers' proposed tariff revisions. We have good reason to be confident that our 2.5 prediction in this Second Further Notice is a reasonable one because it is based on long term, statistically sound data.

55. At the same time, we do lack the same degree of corroboration for that prediction as we have obtained for AT&T through an evaluation of its post-divestiture productivity performance. Although the record contains data and other evidence relating to LEC productivity during this relatively brief period (1984-88), including several studies submitted by interested parties, such evidence is not as meaningful as similar evidence for AT&T for numerous technical reasons.[31] In addition, the evidence in the record does not preclude possible variability of individual LEC productivity around the industry average. Therefore, in keeping with our determination that the

---

31 The technical problems with this record evidence, including methodological errors contained in several of the most ambitious and detailed studies of LEC productivity filed in the record, are discussed in detail in an appendix to this Order. See Appendix E, supra. Once adjustments are made to correct for such errors, the results of the studies tend to fall into the same range as our own estimate of 2.5 percent.

public interest will best be served by implementing caps in a cautious manner, we propose to modify our price cap plan for LECs by adding to it a "backstop" designed to address this uncertainty about LEC productivity. Our primary proposal for this backstop is a mechanism we refer to as an automatic stabilizer. This mechanism will work in conjunction with the price cap formula to adjust LEC rates whenever it appears that rates may fall outside the zone of reasonableness for tariff review purposes. We also seek comment on an potential alternative to the stabilizer, which would consist of a detailed review of the LEC price cap system initiated two years after the first LEC price cap tariffs take effect. We are not proposing to add either suggested "backstop" to the AT&T plan because the record evidence of its productivity does not reflect the same uncertainty as it does with regard to the LECs.

56. As we discussed in the Further Notice, the addition of an automatic stabilizer may weaken incentives for dominant carriers to engage in the kinds of efficiency-enhancing activities that redound to the benefit of consumers. We have attempted to construct the mechanism in a manner which weakens such incentives as little as possible. Thus, we tentatively conclude that the addition of such a mechanism to the LEC price cap system is, on balance, a net benefit to the public because, as we implement this new approach to regulation, it is prudent to provide strong assurances that LEC rates will remain within the zone of reasonableness.

57. The remaining text of this Report and Order and Second Further Notice of Proposed Rulemaking is divided into several sections. In Section II, we analyze our existing regulatory methods and conclude that they are inherently flawed. This section then explores how incentive-based regulation differs from rate of return, and concludes with a finding that incentive regulation is a superior method of regulating AT&T and the LECs. In Section III, we explain and adopt a specific plan for price cap regulation of AT&T. In Section IV, we present our proposed price cap plan for LECs. In Section V, we discuss our legal authority to adopt price cap regulation for AT&T and a variant of that system for LECs. The remaining sections of this Order address legal and regulatory requirements applicable to this proceeding.

II. DOMINANT CARRIER REGULATION

A. Current Approach: Rate of Return Regulation

1. Summary of Further Notice

58. In the Further Notice, we discussed our tentative view that rate of return regulation has several significant inherent flaws.[32] We found that

---

32 3 FCC Rcd at 3217-28 (paras. 33-56).

while a properly administered rate of return system could duplicate competition in the sense of maintaining "normal" profits, rate of return is not able to drive carriers to engage in the same type of efficiency-enhancing and innovative behaviors that mark the operations of competitive enterprises.[33] Without incentives that encourage entrepreneurial decision-making, rate of return produces rates that reflect unnecessary costs, including the opportunity cost of innovations foregone that would have lowered the cost of providing service.[34]

59. We also tentatively found that our manner of focusing on the profit levels of rate of return carriers, in addition to fostering unnecessary costs, presents difficult and complex problems in our efforts to guard against cross-subsidization.[35] Although we have made great strides in promulgating policies that deter cost-shifting activities, the Further Notice tentatively found that our efforts do not eliminate the powerful incentives rate of return creates to load costs onto less competitive rate of return regulated activities. We also tentatively found that the standard tool used to deflect cost shifting -- fully distributed costing (FDC) -- lacks any relationship to the factors that, in a competitive arena, would dictate market entry and pricing decisions. As a result, we tentatively found that the use of the FDC method produces distortions in the decisions made to produce a service and in the pricing of services, distortions that would not exist but for regulation.[36]

60. We also tentatively found that rate of return regulation was inherently expensive to administer due to the large volumes of cost and earnings data that are required to review proposed rates.[37] We cited recent developments in case law that limit our ability to enforce the profit limitations that we establish for dominant carriers as an additional reason to seek out alternatives to traditional rate of return mechanisms.[38] In addition, we tentatively found that the use of regulatory "lag" between rate of return adjustments does not produce incentives to efficiency that are

---

33 Id. at 3218-23 (paras. 38-47).

34 Id.

35 Id. at 3223-27 (paras. 48-53).

36 Id.

37 Id. at 3227 (para. 55).

38 Id. at 3227 (para. 54).

strong enough to overcome the tendency of rate of return firms to operate inefficiently.[39]

61. The flaws we observed in rate of return methodology led us tentatively to conclude that no amount of modification to the existing regulatory regime would correct the problems we identified. We tentatively found that the public interest would be better served by seeking out a more effective means of regulating dominant carriers.[40]

2. Pleadings

a. Cost incentives

62. Our observations on the effectiveness of rate of return regulation drew comments from a number of parties. One group of commenters, including the dominant carriers, agreed with our view that rate of return does not yield optimal economic efficiencies in the provision of common carrier service.[41] NYNEX, for example, classifies the perverse incentive structure created by rate of return as the "most serious" problem associated with a rate of return structure.[42] Alltel argues that rate of return, while useful regulatory tool in an era of the regulated monopoly, is increasingly inadequate in an era of emerging competition for telecommunications services.[43]

63. Others found that we overstated the problems of rate of return regulation.[44] CFA, for example, argues that the Further Notice focused on potential problems of rate of return, instead of the true record of existing

---

39 Id. at 3254-55 (paras. 105-06).

40 Id. at 3228 (para. 56).

41 SBA Comments at 3-4, 8; NYNEX Comments at 7-8; NTIA Comments at 2-3; EDS Comments at 1-2, 7-8; CCIA Comments at 2; CBT Comments at 2; AT&T Comments at 2; Illinois Comments at 11; Alltel Comments at 1-2; NYNEX Reply at 49.

42 NYNEX Comments at 7.

43 Alltel Comments at 1.

44 SNET Comments at 2; Indiana UCC Comments at 5; CFA Comments at 3-6; API Comments at 10; Florida's Citizens Reply at 1-2; DCPC Reply at 6-7; Indiana UCC Reply at 5-7; Texas PUC Reply at 3; Alabama PSC Reply at 1-2; Ohio PUC Comments at 2 (but agreeing that price caps might be a better regulatory technique than rate of return). See also AARP Comments at 2 (arguing that the need for price caps has not been adequately demonstrated).

regulation. According to CFA, examination of the actual performance of rate of return demonstrates that it has caused the real cost of telephone service to drop by more than 60 percent over the last 50 years, while encouraging impressive productivity gains, technological advances, and stable earnings.[45]

64. Commenters also split over whether rate of return produced rate base padding, known as the "Averch-Johnson" effect,[46] or the accumulation of unnecessary expenses, known as "X-inefficiencies."[47] EDS, a provider of data processing, facilities management, and systems integration services, states that it has witnessed cases in which carriers have preferred to employ capital intensive solutions to problems over more efficient alternatives.[48] Other parties argue that the economic literature casts significant doubt as to whether the Averch-Johnson effect actually occurs in "real world" situations.[49] Finally, several parties agree with our analysis that rate of return leads carriers to incur unnecessary expenses.[50]

65. Our statements questioning the ability of regulatory lag to introduce efficiency incentives into existing regulation drew comments from

---

45 CFA Comments at 3-6.

46 See Averch & Johnson, Behavior of the Firm Under Regulatory Constraints, 52 Amer. Econ. Rev. 1052 (1962). As we described in the Further Notice, when the allowed rate of return exceeds the cost of capital, regulated entities can enhance revenues by enlarging their capital investment base. When the cost of capital exceeds the allowed rate of return, carriers can expand revenues by adopting inefficient labor intensive approaches to their business. Further Notice, 3 FCC Rcd at 3219 n.59.

47 See Leibenstein, Allocative Efficiency vs. X-Efficiency, 56 Amer. Econ. Rev. 392, 392-415 (1966).

48 EDS Comments at 2, 7-8. See also NTIA Comments at 2-3; Illinois Comments at 6; Ad Hoc Comments at 33; Texas PUC Reply at 2 (all concurring that the Averch-Johnson theory has a basis in fact).

49 Colorado OCC Comments at 7-8 (citing Bonbright, Danielsen & Kamerschen, Principles of Public Utility Rates, Public Utilities Reports (1988)); New Hampshire PUC Comments at 21-22 (citing Albery & Sievers, The Averch-Johnson-Wellisz Model and the Telecommunications Industry, 40 Fed. Comm. L.J. 157 (1988)); AARP Comments at 12-17, 42 (reviewing the economic literature exploring the Averch-Johnson effect in the electric utility industry). See also API Comments at 10; Oregon PUC Reply at 3-5 (arguing that empirical data of the costs of rate of return are sparse).

50 NTIA Comments at 2-3; Illinois Comments at 6; Ad Hoc Comments at 33.

several parties. NARUC, for example, argues that we have failed to establish that the use of regulatory lag in the context of rate of return regulation would not produce efficiency incentives at least as great as those we anticipate will be produced under incentive regulation.[51] The Colorado OCC states that the possibility of underearning, together with the operation of regulatory lag, produces substantial incentives to efficiency.[52]

66. In addition to these criticisms of our tentative findings, ICA argues that to the extent rate of return regulation has resulted in inefficient operations, the blame should rest on our administration of rate of return and not on the regulatory mechanism itself.[53] ICA concludes that this Commission's administration of our regulatory program has not been an "ideal" test of the rate of return methodology.

b. Innovation

67. Several commenters agree with our view that rate of return does not encourage carriers to innovate since profits are capped on successful innovations and shareholders can be forced to bear the burden of unsuccessful innovations.[54] The most extensive treatment of this issue is contained in the National Telecommunications and Information Administration's (NTIA) Regulatory Alternatives Report, submitted with NTIA's comments leading up to the Further Notice. NTIA argues that rate of return is likely to influence or distort carrier decisions about whether and how to deploy the fruits of research and development, how many resources to commit to innovation, and the rate of innovation.[55] Other parties disagree. The Colorado OCC argues that factors such as regulatory lag, professional pride, and the ability of a carrier to increase sales by lowering prices contradict the notion that rate of return does not encourage innovation.[56] The Texas PUC and consumer

---

51 NARUC Reply, App. C. See also Indiana UCC Comments at 4-5; Colorado OCC Comments at 6-7; New York DPS Comments at 45; MCI Comments, App. (ICF Report) at 14-16.

52 Colorado OCC Comments at 6-7.

53 ICA Comments, Att. B (BRI Report) at 1-12. See also Texas PUC Reply at 2.

54 SBA Comments at 8; NYNEX Comments at 7; EDS Comments at 1-2, 7-8; CCIA Comments at 4; Illinois Comments at 7; Alltel Comments at 1-2. See also Ohio PUC Comments at 2 (arguing that caps may provide better incentives for innovation). Contra Indiana UCC Comments at 5; CFA Comments at 2-4.

55 NTIA, Regulatory Alternatives Report at 18-21 (1987).

56 Colorado OCC Comments at 8-9.

groups state that rate base regulation has in fact produced a number of technological innovations, as witnessed by the technological advancement of the Nation's telecommunications system.[57]

68. Other parties take issue with the factual basis for our observations on innovation and rate of return. MCI argues that the costs of unsuccessful innovations are almost always borne by ratepayers.[58] According to MCI, if profits on successful innovations are limited by pre-determined profit levels, while the costs of unsuccessful innovations are carried in the revenue requirement, the net effects on incentives to innovate are "ambiguous."[59] Bell Atlantic takes issue with MCI's view, arguing that MCI's argument can only be correct if innovation is construed in the narrow sense of research and development.[60]

69. The New Hampshire PUC argues that other options are available, short of abandoning rate of return, for this Commission to solve our concerns about innovation. The New Hampshire PUC suggests that it is possible simply to introduce increased rate flexibility for innovative services under rate of return.[61] SWB argues, however, that more sweeping reform is needed to prevent the Nation's telecommunications network from falling behind those of other countries.[62]

c. Cross subsidization and pricing efficiency

70. Commenters have expressed substantially less concern regarding our conclusions that rate of return raises issues of cross subsidization and fails to achieve efficient pricing for dominant carriers generally. Several parties commenting on this issue agree with our tentative conclusion.[63] Illinois, for example, states that the cost allocation systems used by regulators to

---

57 Texas PUC Reply at 2-3; Indiana UCC Reply at 5-7; UCC Reply at 2-4.

58 MCI Comments at 51-54, App. (ICF Report) at 19-23. See also Colorado OCC Comments at 9.

59 MCI Comments at 53.

60 Bell Atlantic Reply at 25 n.54.

61 New Hampshire PUC Comments at 12.

62 SWB Reply at 8-11, App. II.

63 Illinois Comments at 7-8; SWB Reply at 18-20. See also Colorado OCC Comments at 10.

determine costs of particular services are "artificial and arbitrary constructs."[64] Two commenters question our ability to alleviate these concerns. The New York DPS argues that so long as telephone companies maintain market power, some form of regulation is required to prevent the overpricing of inelastic services.[65] The New Hampshire PUC blames cross subsidization problems on our own "vacillations" on costing matters.[66]

d. Administrative savings

71. Several commenters agree with our view that rate of return is difficult to administer.[67] Illinois argues that the adversarial nature of the rate of return process requires the expenditure of large amounts of time and money, given the need to examine a carrier's rate base to calculate the cost of capital and the authorized rate of return, and to make the necessary cost allocation decisions.[68] Moreover, Illinois states, rate of return requires a heightened level of regulatory oversight, since rate of return creates incentives for carriers to engage in behavior that is contrary to regulatory goals.[69] NTIA's Regulatory Alternatives Report, submitted into the record of this proceeding in comments that led up to the Further Notice, found that administration of rate of return regulation is extremely difficult in an environment of emerging competition or changing technology. According to NTIA, rate of return forces regulators to make arbitrary decisions in the context of quasi-judicial, adversarial proceedings that substitute regulatory judgments for management decisionmaking.[70] Others argue that we have not supported our tentative conclusion that administrative costs of rate of return are high. The Ohio PUC, for example, states that if we were concerned about

---

64 Illinois Comments at 7-8. See also NTIA, Regulatory Alternatives Reportat 13-14, 27 (1987) (finding that the cost allocation decisions regulators must make under rate of return are arbitrary and interfere with efficient pricing decisions, and that rate of return provides incentives to shift costs from nonregulated activities to regulated activities).

65 New York DPS Comments at 46.

66 New Hampshire PUC Comments at 22.

67 NYNEX Comments at 9; CCIA Comments at 4; Illinois Comments at 8-9; Centel Comments at 3; BellSouth Reply at 4. Contra Arkansas PSC Comments at 5.

68 Illinois Comments at 8-9.

69 Id. at 9.

70 NTIA, Regulatory Alternatives Report at 13-15 (1987).

the administrative costs of rate of return, the rational response would have been to examine ways to modify rate of return.[71] According to the New Hampshire PUC, one alternative would have been to streamline rate cases as a means of reducing administrative burdens.[72] In addition, the New Hampshire PUC states that since rate of return is an account-based system, the "obligatory" costs to carriers of administering it should be small.[73]

e. Need for further study

72. A number of parties conclude that we have not made our case that rate of return is in need of replacement.[74] Several parties argue that we have provided no empirical evidence that a change from rate of return regulation is required.[75] Others contend that, in conducting this proceeding, we are acting with unnecessary haste.[76] The Colorado OCC charges that our Further Notice uses our existing rate of return mechanism as a "straw man" to hold up against an idealized version of incentive regulation, rather than thoroughly exploring all possible alternatives.[77]

73. Several parties suggest that we ought to focus our attention on fine-tuning rate of return.[78] ICA suggests that we ought to consider some of the ongoing experiments at the state level in rate flexibility in lieu of

---

71 Ohio PUC Comments at 3.

72 New Hampshire PUC Comments at 19-20.

73 Id. at 19.

74 SBA Comments at 2, 8; Indiana UCC Comments at 6, 27; Arkansas PSC Comments at 4-5; API Comments at 13; Wisconsin PSC Comments at 1-2; ALC Comments at 5, 12-17; NARUC Reply at App. D; NTN Comments at 2-3; Hawaii Comments at 1-2.

75 Indiana UCC Reply at 4-5; Hawaii Comments at 5-6; Maryland PC Comments at 1-2. See also CFA Reply at 3-4.

76 Arkansas PSC Comments at 4; NTN Comments at 1-6; DCPC Reply at 7; Ad Hoc Comments at 10-11.

77 Colorado OCC Comments at 2, 24-32. See also CFA Comments at 3-4; NARUC Reply, App. C; Indiana UCC Reply at 7-8.

78 CFA Comments at 3, 7-8; Comptel Reply at 20-23; Maryland PC Comments at 2. See also Connecticut OCC Comments at 3-5 (the benefits available under incentive regulation ought to be available under a properly administered rate of return system).

adopting the incentive system we proposed.[79] ALC argues that a number of important issues affecting interexchange competition remain unresolved while we consider replacing rate of return, and that resolution of those issues is far more important than implementing incentive regulation.[80]

74. Other parties respond that further study of price caps is unnecessary, given that this Commission has been studying the issue since August 1987, and that many states already have adopted various forms of incentive regulation.[81] Ameritech argues that the demands made by several commenters for empirical evidence are far too stringent, and that no regulatory reform could be introduced if subject to such a test.[82] Ameritech also argues that if one agrees that there are problems with administering a rate of return system, then any change represents an improvement over the status quo and ought to be viewed favorably.[83] Finally, BellSouth simply contradicts those seeking further study, arguing that the record is clear that incentive regulation is a better system.[84]

3. Discussion

75. In this section, we consider whether the flaws we perceive in rate of return methodology are sufficiently embedded within its structure to warrant our discarding rate of return regulation for AT&T and local exchange carriers in favor of another approach to regulating those carriers. We have also been challenged by commenters to consider whether it is our administration of rate of return, rather than the system itself, that produces the problems we have found. On both counts, we affirm our tentative views set forth in the Further Notice that our existing rate of return regulation system should be replaced where feasible.

76. The flaws we have cited with regard to rate of return appear to us to be no less endemic today than when we initially examined rate of return

---

79 ICA Comments, App. B (BRI Report) at 59-68.

80 ALC Comments at 29-34 (citing the 800 database issue, alternative access arrangements, intraLATA equal access, and operator services as issues currently pending that should be resolved). See also MCI Comments at 57-62.

81 USTA Reply at 1; BellSouth Reply at 7.

82 Ameritech Reply at 14-16.

83 Id. at 6-7.

84 BellSouth Comments at 5-6; BellSouth Reply at 2-3.

in the course of this proceeding.[85] Rate of return regulation is a methodology designed to address the problem of constraining market power exercised by monopoly utilities. The principal method by which it constrains market power is through the limitation of a carrier's ability to earn supranormal profit. Viewed at its most elemental level, rate of return requires regulators to limit a carrier's earnings to "normal" levels of profit, thereby preventing the carrier from charging rates that would reveal its true economic position as a monopolist.

77. Unfortunately, rate of return regulation's greatest strength is also its greatest weakness. As we have previously observed, absolute up-front profit constraints, expressed as a prescribed percentage of allowed earnings on investment, do not prevent carriers from increasing their absolute amount of earnings. By expanding its rate base in the course of making investment decisions regarding its regulated activities, a rate of return regulated firm can increase its profits without any change in the allowed rate of return. This phenomenon, known as the Averch-Johnson effect,[86] encourages carriers to make inefficient investment decisions. Furthermore, rate of return does nothing to encourage carriers to limit expenses, since carrier expenses are flowed directly through to revenue requirements, a phenomenon known as "X-inefficiency."[87]

78. While we have enjoyed a degree of success in policing carrier rates for costs that we suspect are attributed to the Averch-Johnson effect or to X-inefficiencies,[88] a vast increase in our resources would be required to enable us to evaluate the multitude of decisions that are made at every level of a carrier's operations every day.[89] Moreover, even if increased

---

85 Notice, 2 FCC Rcd 5208 (1987).

86 See Averch & Johnson, Behavior of the Firm Under Regulatory Constraints, 52 Amer. Econ. Rev. 1052 (1962).

87 See Leiberstein, Allocative Efficiency vs. X-Efficiency, 56 Amer. Econ. Rev. 392, 392-415 (1966).

88 Further Notice, 3 FCC Rcd at 3221-22 (para. 41)(noting that in the past two years, we have disallowed more than $163 million in dominant carrier investments and ordered switched access charge reductions of nearly $900 million).

89 For example, in the Further Notice we cited AT&T's 1988 capital program as involving tens of thousands of work orders, each of which has an effect on costs. Id. at 3224 (para. 50). As we said in the Further Notice, the magnitude of carrier operations in comparison to regulatory resources for oversight is most obviously demonstrated in the number of persons employed by this Commission's Common Carrier Bureau versus the number employed by the

resources were made available for oversight, we could not hope to secure the kind of information that would permit us to second-guess a carrier's managers. In addition, if we were to try to make these type of judgments, it would be very difficult to enforce them, given the latitude conferred upon utility management by recent case law.[90]

79. While several commenters agree with us that the Averch-Johnson effect produces measureable changes in investment decisions,[91] there are several parties that challenge its existence.[92] They point to studies in which the Averch-Johnson effect could not be demonstrated empirically. We are aware of the difficulties that arise in an attempt to measure the Averch-Johnson effect.[93] As the commenting parties themselves have noted, the ability to capture the phenomenon of rate base padding depends on the assumptions made at the outset by the investigator. And while there are studies that are unable to quantify its effect, there are also studies that demonstrate that the Averch-Johnson effect exists.[94] While we view rate base padding as a real and substantial concern, we also believe there is little need to reduce the debate about the efficacy of rate of return to a

---

carriers. Carriers together employ over 100,000 personnel, while we have only 350 employees in the Common Carrier Bureau. Further Notice, 3 FCC Rcd at 3224 n.71.

90 See Jersey Cent. Power & Light v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) (en banc) (plurality opinion) (investment cannot be disallowed from the rate base if it was "prudent when made").

91 E.g., EDS Comments at 2, 7-8; NTIA Comments at 2-3; Ad Hoc Comments at 33; Texas PUC Reply at 2.

92 No party has directly challenged the existence of X-inefficiencies. But see BellSouth Comments at Attachment (Statement of A. Kahn & W. Shew) at 5-6 (arguing that empirical evidence of X-inefficiencies is slim).

93 See Further Notice, 3 FCC Rcd at 3220 (para. 40).

94 See, e.g., Courville, Regulation and Efficiency in the Electric Utility Industry, Bell J. of Econ., 53-74. Accord Spann, Rate of Return Regulation and Efficiency in Production: An Empirical Test of the Averch-Johnson Effect, Bell J. of Econ., 38-52 (1974); Peterson, An Empirical Test of Regulatory Effects, Bell J. of Econ., 111-26 (1975); Hayashi & Trapani, Rate of Return Regulation and the Regulated Firm's Choice of Capital Labor Ratio, Southern J. of Econ., 384-98 (1976); Atkindson & Halvorsen, A Test of Relative and Absolute Price Efficiency in Regulated Industries, Rev. of Econ. & Statistics, 81-88 (1980); Gegax & Tschirhart, An Analysis of Interfirm Cooperation, Southern J. of Econ., 1077-97 (1984).

disagreement over techniques to measure the Averch-Johnson effect. As NTIA argues, regardless of one's view on the real-world existence of rate base padding, there is little dispute that rate of return directly and substantially affects carrier behavior.[95] A regulatory system that can achieve the statutory goal of just and reasonable rates in an equal (let alone better) fashion, while minimizing government influence on carrier operations, is far more desirable than the present system of regulation.

80. Nor are we convinced that regulatory lag, that period of time in which the rate of return represcription process has not yet caught up with changing carrier costs, can suffice to introduce the degree of efficiency incentives that we can expect to create with alternative, incentive-based regulation.[96] As we said in the Further Notice, regulatory lag exists solely as a result of friction in the rate of return system. In selecting which method best achieves incentives for efficiency, we believe incentive regulation is superior. Unlike regulatory lag, which is inherent in rate of return because it cannot be perfectly enforced, incentive regulation is designed from its foundation to take advantage of incentives to efficiency.

81. We also continue to believe that evidence of the achievements of the dominant carriers in constructing and maintaining an advanced telecommunications network does not demonstrate that existing regulation is the cause of the present high level of service quality provided by the industry, both in terms of transmission quality and reasonably short service intervals. No party has disputed our analysis, contained in the Further Notice, that rate of return has been an example of suboptimal regulation for both the electric utility and railroad industries.[97] We therefore reject those pleadings that would have us declare a cause and effect relationship between existing regulation and the current performance of the industry.

82. A corollary to the efficiency concerns raised by rate of return is the argument, advanced in the Further Notice, that rate of return does not encourage innovation in the development of new products and services.[98] Our concern about a carrier's incentive to produce innovative products stems from the identical concern we expressed with regard to general efficiencies

---

95 NTIA Regulatory Alternatives Report, 26 (1987).

96 See Further Notice, 3 FCC Rcd at 3254-55 (paras. 105-106).

97 Id. at 3218 (para. 35). As we stated in the Further Notice, rate of return regulation has not made the electric power industry a leader in efficiency or technology. Under rate of return, the railroad industry experienced bankrupties, and productivity has been generally low.

98 Id. at 3223 (paras. 46-47).

-- that under rate of return, any advancement that lowers carrier costs is supposed to be recaptured immediately by regulators, thereby lessening incentives to lower costs.

83. We acknowledge the tremendous technological innovations that we have witnessed in recent years under rate of return. The issue, however, is not whether innovation has occured under rate of return regulation, but whether the incentive structure created by price caps may do better than rate of return in encouraging a wide range of innovations, including those that will lower carrier costs. We find that it will. So long as regulators regularly recapture efficiencies, including those produced by innovation, and successful innovations are strictly limited to earning the authorized rate of return, there does not appear to be strong motivation for a carrier to develop innovative products or services.[99] Furthermore, while increased rate flexibility for innovative products and services might solve some of our concerns on this particular issue, as the New Hampshire PUC suggests, it does not address the underlying incentives built into rate of return to keep rates high.

84. Fewer commenters took issue with our tentative findings that rate of return lends itself to cross-subsidization, fails to achieve pricing efficiency, and is difficult to administer. There appears to be little disagreement that, under rate of return, carriers have an incentive to shift the costs of nonregulated, competitive activities onto regulated, less competitive services. In the Further Notice, we reviewed the great strides we have made in recent years in establishing regulatory roadblocks to discourage cross-subsidization.[100] Nevertheless, we tentatively found that the policies of deterrence we established do not eliminate the strong incentives established by rate of return regulation to engage in cross-subsidy.[101] We affirm that tentative decision here.[102]

---

99 We are not persuaded by MCI's argument that rate of return may in fact encourage innovation since ratepayers almost always bear the cost of unsuccessful innovation. Assuming arguendo that MCI is correct, placing these costs on ratepayers does not encourage efficient risk taking behavior. Stated differently, a regulatory model that requires ratepayers to pay for unsuccessful innovation may encourage types of risk-taking behavior that a competitive firm would not undertake, to the detriment of ratepayers who should not be required to cover the costs of such investments.

100 Further Notice, 3 FCC Rcd at 3225-26 (para. 52).

101 As we discuss in the implementation section for AT&T, the cross-subsidization problems created by rate of return are substantial. See Section III.C.1, infra. In an environment of emerging competition, the incentives created by rate of return to cross-subsidize more competitive services is reason alone to adopt price cap regulation for AT&T, given our

85. We also find that the administrative burdens imposed by rate of return regulation are significant. The process of acquiring sufficient information to pass judgment on carrier rates requires us to explore complex cost allocation methodologies, evaluate demand predictions, and review comprehensive earnings data.[103] If a simpler method of oversight were available, the savings generated would substantially ease the burdens on the carriers of preparing support materials and would eventually result in lower rates. In addition, simpler filings would, over the long term, lessen the burdens on this Commission, which would free our resources to focus on other important regulatory policies, such as the enforcement of market rules that foster competition. We recognize that the process of initiating incentive regulation, while retaining rate of return for some carriers, means that the administrative burdens on this Commission will not decrease substantially in the short term. Nevertheless, some savings will accrue immediately. We acknowledge those comments that would have us streamline our rate of return apparatus to produce administrative savings. We are constantly working to fine tune our regulatory methods so as to alleviate unnecessary burdens.[104] Reduction of rate of return burdens, however, does not address the problems we have identified with that form of regulation.

86. We also disagree with those parties that allege that the case for abandoning rate of return for some carriers has not been established and that

---

history of adopting policies that are intended to limit potentially anticompetitive behavior.

102 Like the New York DPS, we believe that the market power exhibited by dominant carriers in today's environment demands continued scrutiny by regulators. Our plan to implement incentive regulation for AT&T in the form of price caps evidences our intent to maintain regulatory oversight. We do not agree with the New Hampshire PUC that cross-subsidization concerns are a function of this Commission's decision-making on cost allocation issues. Regardless of what cost allocation method is employed, rate of return creates incentives for carriers to shift costs to less competitive activities.

103 In the Further Notice, we cited a study by the NTIA finding that nationally, the cost of rate of return regulation is $1 billion annually. NTIA, Regulatory Alternatives Report at 17 (1987).

104 See, e.g., Regulation of Small Telephone Companies, 2 FCC Rcd 3811 (1987) (reducing tariff and data filing requirements for small LECs) and Access Filings of Small Companies, 3 FCC Rcd 7173 (1988) (granting a blanket waiver for any small LEC filing its own access tariff to refer to NECA's simplified terms and conditions in the NECA access tariff).

further study is required. Since the initiation of this proceeding in August of 1987, the problems with rate of return methodology have been one of the chief focal points in the debate over whether to adopt incentive regulation for interstate dominant carriers. The record in this proceeding contains more than 6,000 pages of ideas, data, arguments, and other materials that we collected in response to the Notice, and over 5,000 additional pages of material collected in response to our detailed proposal contained in the Further Notice. Over 80 parties participated in each of these rounds. Numerous suggestions have been made in the course of the debate to modify rate of return in an effort to solve one or more of this Commission's concerns, but none address in a comprehensive way the faulty incentive structure of rate of return. Nor do we agree that empirical evidence establishing with precision or certainty the costs created by rate of return is feasible or necessary before we proceed. Our analysis of rate of return is grounded in decades of our own experience, as well as the contributions of scholars at both the theoretical and empirical level.[105] The criticisms of rate of return regulation we have cited are widely-accepted and widely-discussed. We therefore find that the flaws inherent in rate of return regulation are so embedded in the nature of the regulatory system itself that exploration of alternative methods of regulation is in the public interest. We now turn to the issue of whether incentive regulation in fact constitutes a better alternative.

B. Incentive Regulation

87. In this section, we discuss incentive regulation of the type proposed in the Further Notice. Our purpose here is to compare and contrast the two regulatory methods, both of which are intended to limit the ability of dominant carriers to exercise their market power, to determine whether incentive regulation is superior.[106] By incentive regulation, we mean any

---

105 A. Kahn, The Economics of Regulation 48 (1971)(explaining the theoretical basis for the Averch-Johnson effect); T.K. McCraw, Profits of Regulation 13 (1984); Primeaux, An Assessment of X-Efficiency Gained Through Competition, Rev. of Econ. & Stat. (Feb. 1977); Courville, Regulation and Efficiency in the Electric Utility Industry, Bell J. of Econ., 53-74 (1974). See also Further Notice, 3 FCC Rcd at 3220 n. 62 (citing other articles on the inefficiency of rate of return).

106 We will not, as part of this section, discuss or respond to claims by some parties that particular adverse consequences will result from the adoption of our price cap plan set forth in the Further Notice. The validity of those concerns, such as statements about what will happen to service quality or consumer benefits, depends on the entities to which incentive regulation is applied and the structure of that incentive system. For AT&T, those concerns will be addressed as part of our examination of whether the price cap proposal set forth in the Further Notice is a better regulatory

regulatory mechanism that employs the same incentive found in competitive markets -- the dynamic process that results from the drive to earn profits -- as a means of stimulating carriers to provide more efficient and innovative services at prices resembling those that would be found in the competitive marketplace. While various forms of incentive regulation exist,[107] all share the common denominator of rejecting a limit on carrier earnings as a means of maximizing consumer welfare, and all involve placing a limit on the prices a carrier can charge for its services.

1. Summary of Further Notice

88. The Further Notice tentatively concluded that there are substantial benefits to designing a regulatory system that works in harmony with profit-making incentives, instead of against them.[108] As portrayed in the Further Notice, incentive regulation focuses in the first instance on the incentive to generate profits as a means of ensuring that carriers will become more efficient and innovative in serving the public. By capping or limiting prices, instead of prescribing profits, incentive regulation enables carriers to generate profits above the current authorized return if they can introduce efficiencies and innovations that reduce their costs from current levels.[109] If they cannot, carriers' profits are likely to be below current authorized levels. We tentatively found that the efficiency gains that incentive regulation would produce represent a true gain to the economy (since carriers would be producing the same output at less cost).[110]

89. Our ability to harness efficiency incentives under incentive regulation was not the only benefit we found. Since incentive regulation does not require us to set in advance a particular, rigid profit limit, carriers under incentive regulation will have greater incentives to

---

system for examining the justness and reasonableness of AT&T's rates. See generally Section III, infra. For the LECs, those concerns will be addressed in the course of our discussion concerning implementing incentive regulation for them. See generally Section IV, infra.

107 The Further Notice discussed in detail two principal variants of incentive regulation being practiced today: (1) New York's rate moratorium plan; and (2) the United Kingdom's price cap system. Further Notice, 3 FCC Rcd at 3229-40 (paras. 57-81).

108 Id. at 3253-60 (paras. 102-18).

109 Id. at 3253-56 (paras. 103-10).

110 Id. at 3253-54 (para. 103).

innovate.[111] Furthermore, incentive regulation makes it far more likely that efforts to innovate will be market-driven, and hence, of benefit to a broad range of consumers.[112] In addition, by reducing the importance of reported cost allocations, we tentatively found that the ability to engage in cross-subsidization is substantially curtailed.[113]

90. We also found that by providing some flexibility for carriers to alter existing price structures, incentive regulation is likely to pull carriers in the direction of the most economically efficient set of rates.[114] Instead of having prices dictated by a costing methodology employed to satisfy the requirements of regulators, economic theory teaches that for-profit firms will pursue price changes that both recover total company costs and enhance the consumer surplus.[115] Finally, we also tentatively decided that incentive regulation will reduce the cost of administering a regulatory structure in the long run.[116]

2. Pleadings

a. Cost incentives

91. A number of parties, including the dominant carriers, agree that incentive regulation of the type portrayed in the Further Notice, would spur carriers to become more efficient.[117] EDS, for example, views incentive

---

111 Id. at 3255-56 (paras. 107-10).

112 Id. at 3256 (paras. 109-10).

113 Id. at 3257 (paras. 111-12).

114 Id. at 3257-58 (paras. 113-15).

115 Id. We define consumer surplus as the difference between the actual price of a commodity or service and the price consumers would be willing to pay for that commodity or service. Price decreases, therefore, increase the size of the consumer surplus. Further Notice, 3 FCC Rcd at 3257 n.208.

116 Id. at 3259-60 (paras. 116-18).

117 NYNEX Comments at 6-9; CCIA Comments at 3; CBT Comments at 2-3; Illinois Comments at 10-11; United Comments at 3; Pactel Comments at 4-5; NAM Comments at 2; IIA Comments at 1; GTOC Comments at 2; Comsat Comments at 2; Centel Comments at 2; BellSouth Comments at 3, 12-13; Bell Atlantic Comments at 3; SWB Comments at 5; Ameritech Comments at 3; US West Comments at 5-6, 15; USTA Reply at 3; US West Reply at 2; NYNEX Reply at 49; AT&T Reply at 2. MBS, in an AT&T-funded review of existing studies on the impact of incentive regulation or deregulation, argues that if incentive regulation

regulation as "critically important" if carriers are to have an incentive to operate their networks efficiently and to modernize.[118] AT&T "strongly endorse[s]" the view that incentive regulation promotes efficiency.[119] BellSouth finds that incentive regulation encourages long run improvements in carrier efficiency that can and will be shared with consumers.[120] US West states that incentive regulation is "demonstratively consistent with and in furtherance of the Commission's public interest mandate."[121] Illinois argues that incentive regulation holds much potential since carriers will be motivated to produce services efficiently.[122]

92. Other parties disagree with these views, primarily because they find no reason to depart from rate of return.[123] In addition, other parties opposing the Further Notice make several different arguments disputing our analysis of the efficiency benefits of incentive regulation. The Wisconsin PSC argues that the presence of competition, not the type of regulation imposed, spurs carriers to become more efficient.[124] ICA states that by failing to set profit limits, we will be permitting carriers to reap a benefit from the inefficiencies generated by rate of return regulation or from efficiency-enhancing technologies that have been financed by ratepayers.[125] The Connecticut OCC disputes the notion that, to generate efficiencies,

---

results in a 5 to 10 percent decrease in aggregate prices, positive economic results will be obtained. As examples, MBS cites an increase in the gross national product, a decrease in the federal debt, and an increase in employment. MBS Comments at 5.

118 EDS Comments at 1-2 (arguing that to compete in a global economy, dominant carriers need incentives to be efficient and to improve their networks).

119 AT&T Comments at 2.

120 BellSouth Comments at 12.

121 US West Comments at 5-6.

122 Illinois Comments at 11.

123 Indiana UCC Comments at 4-5; Michigan PSC Comments at 6; IDCMA Comments at 3; Ohio OCC Reply at 1; DCPC Reply at 3-4.

124 Wisconsin PSC Comments at 1-2. See also ICA Comments, App. B (BRI Report) at 81.

125 ICA Comments, App. B (BRI Report) at 80-81.

carriers must be prodded with the possibility of earning excess profits. According to the Connecticut OCC, the chance to earn just and reasonable profits ought to be sufficient incentive.[126] The Colorado OCC also argues that to the extent the Averch-Johnson effect exists, a change in regulatory structure will not eliminate it since shareholders do not themselves manage common carriers.[127] Finally, the Oregon PUC argues that the studies we have cited to support our tentative view of incentive regulation are more inconclusive than the Further Notice would indicate, and are even disputed by carriers.[128]

b. Innovation

93. A number of parties support our tentative view that incentive regulation will tend to encourage innovation.[129] NYNEX argues that incentive regulation encourages the introduction of new services that might entail a greater degree of risk, since incentive regulation holds out the promise of greater returns.[130] IIA argues that a carefully-designed system of incentive regulation is capable of increasing the technological capabilities of the dominant carriers' networks.[131] Several parties, however, dispute our tentative findings. The Colorado OCC argues that if incentive regulation forces shareholders to finance innovation, efforts to innovate may be reduced.[132] Similarly, Illinois argues that by setting limits on aggregate prices, incentive regulation may discourage some innovations from being developed and introduced, even if consumers would be willing to pay more for the innovation than the price cap would allow.[133] Illinois also argues that

---

126 Connecticut OCC Comments at 4-5.

127 Colorado OCC Comments at 5-6. See also Michigan PSC Comments at 3 (expressing doubt that the Averch-Johnson effect will disappear if rate of regulation is replaced).

128 Oregon PUC Reply at 6-9.

129 NYNEX Comments at 6, 8, 35; CBT Comments at 2-3; USTA Comments at i; United Comments at 3; IIA Comments at 1-2; GTOC Comments at 2; BellSouth Comments at 3, 13; Bell Atlantic Comments at 3; SWB Comments at 5; NYNEX Reply at 49. Contra Ohio OCC Reply at 1.

130 NYNEX Comments at 8.

131 IIA Comments at 2.

132 Colorado OCC Comments at 9.

133 Illinois Comments at 12.

incentive regulation renders innovation a risk-taking activity, which may lead the carrier to decide not to fund innovative ideas that appear more risky.[134] In addition, the Ohio OCC argues that government policies do not influence the rate of innovation.[135]

c. Cross-subsidization and pricing efficiency

94. Our tentative views on how incentive regulation affects cross-subsidization and pricing efficiency drew a number of comments from parties. Several parties simply agree with our tentative views.[136] Pactel, for example, argues that by removing the requirement that service prices reflect a regulatorily-imposed cost allocation system, needed pricing flexibility can be introduced that will promote efficient use of the network.[137] Some states and consumer groups disagree. The New York DPS argues that the cross subsidization concerns that existed under rate of return will not disappear with the advent of incentive regulation.[138] The AARP, citing the example of the consumer credit industry, argues that setting maximum price limits will not cause prices to drop below maximum levels, and is likely to lead to uneconomic unbundling of service elements as a means of increasing profits.[139] The Colorado OCC argues that incentive regulation makes predation less costly than under rate of return, since profit levels are unconstrained.[140] Finally, the New Hampshire PUC argues that if we simply seek to limit opportunities for cross-subsidization, modifications to our existing regulatory structure are possible to sever the ties between costs and revenues, on one hand, and prices, on the other.[141]

95. Several parties argue that our proposal to introduce a measure of pricing flexibility into our plan will result in price increases for those

---

134 Id.

135 Ohio OCC Reply at 2.

136 CCIA Comments at 3, 9; USTA Comments at 7; United Comments at 3; Pactel Comments at 6; US West Comments at 6-7. Contra Florida's Citizens Reply at 2.

137 Pactel Comments at 6.

138 New York DPS Comments at 46.

139 AARP Comments at 2, 18-23.

140 Colorado OCC Comments at 10.

141 New Hampshire PUC Comments at 22.

services over which the carrier maintains market power.[142] The Connecticut OCC asserts that our proposal to employ incentive regulation demonstrates that this Commission is mainly interested in letting residential consumers pay more than high volume users of telecommunications services.[143] The New Hampshire PUC cautions that pricing efficiencies will not be generated if our proposals establish price ceilings at too high a level.[144] The Colorado OCC argues that the optimally efficient set of prices that we seek are impossible to achieve in practice.[145]

d. Administrative savings

96. Our tentative finding that incentive regulation would be less costly to administer also has drawn a number of comments. Many parties, including the carriers, agree that incentive regulation would be less burdensome for them than rate of return.[146] Illinois argues that administrative savings will accrue in the long run, despite intial transaction costs and our tentative decision to retain rate of return for some carriers.[147] Centel argues that it would be unrealistic to expect the Commission to augment its resources to the degree necessary to ensure that all 1400 dominant carriers were not taking advantage of incentives to operate inefficiently under rate of return.[148] According to Centel, substantial cost savings will be realized

---

142 Colorado OCC Comments at 10; New Hampshire PUC Comments at 17-18; Michigan PSC Comments at 3; IIA Comments at 2; Alabama PSC Comments at 2-3. Most parties commenting on this issue did so in the specific context of our basket and band proposal for grouping services under price caps. We deal with those comments in the context of baskets and bands for AT&T, at Section III.C.2, infra, and for the LECs, at Section IV.C.2.b., infra.

143 Connecticut OCC Comments at 6-7.

144 New Hampshire PUC Comments at 28-29.

145 Colorado OCC Comments at 11-12.

146 NYNEX Comments at 9, 36; CCIA Comments at 4; CBT Comments at 4; Illinois Comments at 11-12; USTA Comments at 6; United Comments at 3; GTOC Comments at 2, 4; Centel Comments at 3-4; BellSouth Comments at 3; SWB Comments at 5; Ameritech Reply at 7-8; US West Reply at 2; Pactel Reply at 12; NYNEX Reply at 51. NYNEX, for example, argues that the more than 2,000 pages of tariff support it filed in connection with its 1988 access tariff filings could be reduced to 700 pages under the incentive-based regulatory structure set forth in the Further Notice. NYNEX Reply, App. E.

147 Illinois Comments at 13-15.

148 Centel Comments at 3.

by breaking the tie between costs and prices, as incentive regulation permits this Commission to do.[149] Others strongly disagree with our tentative finding, and in particular, the view that incentive regulation would be less costly for this Commission to administer.[150] The Arkansas PSC argues that there is no comparative evidence demonstrating that incentive regulation is less costly.[151] Several parties argue that incentive regulation is not as simple as the Further Notice suggests. ALC argues that it is not easy to determine if actual prices have exceeded the limit.[152] One party states that incentive regulation is unworkable,[153] while others say that the proposal leaves a number of questions unanswered that will have to be litigated in the future.[154]

97. Several parties argue that this Commission does not have the resources to implement a new regulatory program while maintaining the existing one for carriers that do not elect incentive regulation.[155] Others argue that our proposal demonstrates our lack of commitment to meet user needs.[156] Finally, several parties conclude that even under the most optimistic of scenarios, there will be no adminstrative savings for the first years of the program.[157]

---

149 Id. at 3-4.

150 Colorado OCC Comments at 13; Arkansas PSC Comments at 5; AARP Comments at 2-3, 24-33, 43; Executive Agencies Comments at 9-10; Comptel Comments at 7-8; Ohio OCC Reply at 1; ICA Comments at 10-11; ICA Reply at 4; DCPC Reply at 5; Texas PUC Reply at 2. See also Alabama PSC Comments at 5 (stating that there is some uncertainty as to whether incentive regulation is less costly).

151 Arkansas PSC Comments at 3.

152 ALC Comments at 22-23.

153 NTN Reply at 27-28.

154 Comptel Comments at 35-38; Florida's Citizens Reply at 4-5; Comptel Reply at 19-20.

155 CA Comments at 10-13 & App. B (BRI Report) at 73-74; ALC Comments at 24-25; Comptel Reply at 19-20.

156 ICA Comments at 12-13; ICA Reply at 4-5; Maryland PC Reply at 9.

157 New Hampshire PUC Comments at 20; Illinois Comments at 14-15; ALC Comments at 24-25; Florida's Citizens Reply at 4.

e. Consumer Benefits

98. Carriers agree with our tentative conclusion that consumers would obtain direct benefits from an incentive form of regulation.[158] BellSouth, for example, argues that incentive regulation promises a guarantee of price reductions that is not available under rate of return.[159] BellSouth also argues that under incentive regulation, carriers bear the risk that profits will be volatile, unlike rate of return, which permits carriers to adjust rates to correct for anticipated shortfalls.[160] NYNEX argues that incentive regulation provides increased price stability and predictability, as compared to rate of return.[161]

99. Others argue, however, that incentive regulation primarily benefits carriers, while ignoring the needs of ratepayers. The Michigan PSC argues that because incentive regulation does not compel a complete flow-through of efficiency gains to decrease carrier rates, those services that are noncompetitive will generate excess profits and reduced services at the consumer's expense.[162] Similarly, the Connecticut OCC argues that companies that have failed to serve the public interest under rate of return are unlikely to share efficiency gains with consumers.[163] Maryland PC argues that incentive regulation fails to protect residential ratepayers, while Ad Hoc states that our proposal represents an imbalance of risks and rewards between carriers and consumers.[164] CFA states that this Commission has overestimated consumer benefits under incentive regulation and underestimated the benefits of rate of return. According to CFA, consumers will be denied their fair share of declining costs under the incentive plan.[165] The Colorado OCC argues that there is no evidence that incentive regulation will drive

---

158 United Comments at 2; Pactel Comments at 5, 6; GTOC Comments at 2; BellSouth Comments at 3; Bell Atlantic Comments at 3; US West Comments at 5; AT&T Reply at 2-4; Pactel Reply at 14-16.

159 BellSouth Comments at 12, 15.

160 Id. at 14.

161 NYNEX Comments at 8.

162 Michigan PSC Comments at 3. See also NARUC Reply, App. C.

163 Connecticut OCC Comments at 3-4, 5-6.

164 Maryland PC Comments at 1; Maryland PC Reply at 12; Ad Hoc Comments at 11-12.

165 CFA Comments at 2; see Hawaii Comments at 2-3.

prices down to long run average costs, and that therefore consumers will not benefit.[166] Finally, NTN argues that there is a broad concensus that has developed against price caps, which ought to give this Commission pause as it deliberates on this issue.[167]

3. Discussion

100. Our interest in formulating an alternative regulatory approach for dominant carriers stems directly from our concern with the drawbacks of rate of return regulation. We therefore tend to measure alternative regulatory methods against our rate of return system and, specifically, the four flaws that we have identified with it: (1) incentives for carriers to be inefficient; (2) insufficient incentives to encourage innovation; (3) tendency to foster cross-subsidization and inability to move toward an optimally efficient set of prices; and (4) high administrative costs. As we did in the Further Notice, we find that incentive regulation comes out ahead on all four fronts. In addition to these four areas, we have added a fifth criterion that we have said must be present for us to embrace incentive regulation -- whether consumers will be better off than under rate of return.[168] Therefore, before we decide that incentive regulation is a superior alternative for AT&T and local exchange carriers, we must be satisfied that a new regulatory approach helps solve the problems we have identified with rate of return and ensures that consumers will benefit.

101. The advantages we perceive in adopting incentive regulation are substantial. Most importantly, focusing in the first instance on limiting prices instead of profits dramatically reverses the tendency of rate of return regulated firms to engage in inefficient behavior. Carriers, faced with the inability to raise prices above a pre-set limit, must engage in efficiency-enhancing techniques to generate profits. This is exactly the type of behavior that we observe in firms in the competitive arena, where prices are in effect "set" by the market.

102. Unlike rate of return, incentive regulation is not in conflict with the fundamental consumer welfare-enhancing motivations that are created by competitive forces. Stated differently, the economic basis on which dominant

---

166 Colorado OCC Comments at 13-14.

167 NTN Comments at 4-5.

168 Statement of Dennis R. Patrick, Chairman, FCC Before the Subcommittee in Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, July 13, 1988 (stating that his "most important promise" with regard to implementing incentive regulation is to make consumers better off).

carriers make decisions under incentive regulation is precisely the same as for a fully competitive firm. Once incentive regulation is introduced for dominant carriers, we can expect that more and more efficiencies will gradually be introduced into carrier operations, thereby lowering a carrier's overall costs. The drop in costs associated with production represents a net benefit to the Nation's economy, since the same output is being produced at less cost.[169] We therefore believe that incentive regulation, right from the start, will sharply reduce the tendency of carriers to engage in the types of behavior that have been labelled and measured in the economic literature as the Averch-Johnson effect and X-inefficiencies.[170]

103. Other significant effects flow from incentive regulation, as well. Carriers are encouraged to engage in innovation to a greater degree than they were under rate of return. Under incentive regulation, the risks that carriers take in underwriting innovation, can be matched by rewards that are not limited by a profit cap. While it is true that some potential innovations may not be undertaken in an incentive-based regulatory structure, the decisions about whether to support the development of an innovative product or service are far more likely to be based on factors that competitive firms face in similar circumstances, which will help protect ratepayers against rate base padding through inefficient innovation.[171] Those factors, such as the level of risk and the likely appeal of the good or service in the market,

---

169 In the price cap plan we presented in the Further Notice, we proposed to recapture some of these efficiency gains in the form of price reductions, through a mechanism we termed the "Consumer Productivity Dividend." Further Notice, 3 FCC Rcd at 3407-08 (para. 386). Under this proposal, consumers receive a direct benefit -- lower rates -- from a carrier's efficiency gains.

170 We do not agree with the Colorado OCC's argument that the Averch-Johnson effect will continue unabated under incentive-based regulation. Since aggregate price increases are limited or precluded by incentive regulation, the primary way managers can generate profits for shareholders is to become more efficient. We recognize that by continuing to monitor carriers' returns on investment, and focusing on this issue in Section 204 investigations and Section 208 complaint proceedings, as we proposed to do, the Averch-Johnson effect will be perpetuated to some extent, but we believe the strength of this phenomenon will be substantially attenuated by shifting our regulatory focus in the first instance to prices, not profits.

171 We do not agree with the Colorado OCC's argument that innovation under price caps would be reduced because shareholders will finance it. If this argument were true, private industry in the United States would be less innovative than public utilities, which clearly is not the case.

are better suited to stimulating useful innovation than any incentives that currently exist under rate of return.[172]

104. Furthermore, incentive regulation substantially curtails the economic incentive to engage in cross-subsidization. In an environment of incentive regulation, carriers are limited in their ability to enhance profits by shifting costs from more competitive to less competitive activities, since the cap on prices limits a carrier's ability to raise rates to accommodate the shifted costs. Moreover, incentive regulation eliminates the incentive to shift costs to regulated services from nonregulated services. Under incentive regulation, all that a carrier accomplishes by moving costs to regulated services is to depress earnings, not to increase them. Incentive regulation, coupled with our existing regulatory controls to deter cross-subsidy,[173] should substantially discourage anticompetitive activity involving cost shifting between regulated and nonregulated lines of business.

105. Nor does the limited amount of pricing flexibility we have included in our concept of incentive regulation alter our conclusion. In fact, a carrier's ability to adjust prices constitutes one of the major benefits of incentive regulation. As we said in the Further Notice, theoretically the most economically efficient set of prices a producer could charge would be based on marginal cost.[174] Fully distributed cost, however, does not permit carriers to set prices at levels that even approximate marginal cost. Currently, dominant carrier rates to a large extent reflect our reliance on fully distributed costing, the traditional regulatory tool used to guard against cross-subsidy. Incentive regulation, with its primary focus on prices, permits us to move away from the use of fully distributed costing, and toward a more economically efficient set of prices.

106. In the Further Notice, we found that movement away from FDC-based prices would yield consumer benefits in the form of reducing the consumer welfare loss generated by rate of return regulation.[175] While we agree that

---

172 See Further Notice, 3 FCC Rcd at 3256 (para. 109) & n.205 (under rate of return, carriers sometimes make imprudent attempts to commercialize the fruits of basic research).

173 See Joint Cost Order, 2 FCC Rcd 1298 (1987) modified in recon., 2 FCC Rcd 6283 (1987) (requiring dominant carriers to prepare cost allocation manuals for the separation of regulated and nonregulated costs in conformance with specific cost principles).

174 Of course, in reality it is impossible for every rate to be set at marginal cost in the long run, since no fixed costs would be recovered. Further Notice, 3 FCC Rcd at 3257 (para. 113).

175 We cited one study that estimated the consumer welfare loss to be $1

our policies will never result in perfectly efficient marginal cost prices, we see no benefit to retaining the status quo if we can in fact enhance the consumer surplus. We also believe that movement toward a set of efficient prices can be accomplished in a manner that will further our long-standing interest in protecting residential and small business ratepayers. Indeed, as part of our implementation of a price cap system for AT&T, we have established special protections for residential and small business ratepayers as part of the AT&T price cap system.[176] Furthermore, our poposed LEC price cap system substantially restricts LEC flexibility to change carrier common line rates, which represent one of the principal underlying components of the long distance rates that consumers pay to their long distance carriers.[177]

107. Finally, we believe that a mode of regulation that lessens the tariff filing burdens on carriers, and that ultimately lowers the tariff review burdens on this Commission, represents a substantial improvement over our existing system. The amount of cost support accompanying streamlined, i.e., below-cap and within-band, tariff filings will be minimal, focusing solely on the question of whether the proposed rate has exceeded the limit established by the price cap formula. NYNEX, for example, states that the amount of cost support it would file with its annual access filing would drop from over 2,000 pages to approximately 700 pages under price cap regulation.[178] Furthermore, by eliminating the need to determine in the tariff review process that individual rates are targeted to a pre-set return, we eliminate the need for employing forecasted data to determine that a rate is within the zone of reasonableness. Of course, the size of the administrative savings to be obtained is completely dependent upon the number of dominant carriers that are regulated under an incentive system. Nevertheless, there are incremental benefits to be gained even if just one dominant carrier is regulated under incentive regulation. Our decision to maintain the rate of return regulatory apparatus for those dominant carriers not participating in the incentive system cannot be interpreted as cancelling out any administrative savings to be obtained by using an alternative system.

---

billion annually. Further Notice, 3 FCC Rcd at 3258 (para. 114) citing J. Griffin, The Welfare Implications of Externalities and Price Elasticities for Telecommunications Pricing, 64 Rev. of Econ. & Stat. 59 (1982) (reporting a loss of $1.5 billion annually in 1975 dollars).

176 See Section III.C.2, infra (establishing a system of baskets and bands designed to protect residential and small business ratepayers as part of the AT&T price cap system).

177 See Section IV.C, infra (proposing that the carrier common line charge be placed in its own basket, subject to a special adjustment).

178 NYNEX Reply at App. E.

108. We recognize that prior to implementing incentive regulation, our judgments about the benefits to be obtained from its operation are predictive.[179] Our judgments are not, however, without empirical foundation.[180] A number of states have introduced alternative regulatory

---

179 Reliance on our judgment and prediction is an accepted basis for agency decison-making. See, e.g., FCC v. WNCN Listeners Guild, 450 U.S. 582, 594-95 (1981); Associated Gas Distributers v. FERC, 824 F.2d 981, 1008-09 (D.C. Cir. 1987).

180 In the Further Notice, we cited several studies to support our finding that incentive regulation is a better regulatory tool than is rate of return. We list those studies here. A. Mathios & R. Rogers, The Impact of Alternative Forms of State Regulation on AT&T on Direct Dial Long Distance Telephone Rates, Federal Trade Commission, Bureau of Economics, Working Paper Series No. 159 (Dec. 1987) (finding that AT&T's MTS long distance rates are on average 7 to 10 percent lower in states that have adopted a price cap approach than in states that continue to use rate of return); J. Griffin, The Welfare Implications of Externalities and Price Elasticities for Telecommunications Pricing, 64 Rev. of Econ. & Stat. 59 (1982) (estimating a consumer welfare loss of over $1 billion annually in 1975 dollars from the use of fully distributed costing); I. Bradley & C. Price, The Economic Regulation of Private Industries by Price Constraints, Leicester Univ. Econ. Dept. (1987); I. Vogelsang, Price Cap Regulation of Telecommunications Services: A Long Run Approach, Rand Corp. (1988); T. Brennan, Capping 'Average Prices' of Regulated Multiproduct Firms, Geo. Wash. Univ. (1987); National Telecommunications and Information Administration, Regulatory Alternatives Report (1987) (estimating that the administrative cost of rate of return regulation is likely to be $1 billion annually).

The Oregon PUC, in its reply, takes issue with several studies that we cited in support of incentive-based regulation, arguing that the results of those studies have been called into question, even by proponents of incentive regulation. In support of its contention that the economic literature does not support price cap regulation, Oregon PUC refers to the study by T. Brennan that we listed in the Further Notice, citing language indicating that a price cap system is not desirable. Oregon PUC Reply at 8-9. However, Brennan's criticisms are of a price cap plan that allows pricing flexibility only so long as the average of price changes is negative, and does not adjust prices for changes in costs. This is clearly not the price cap plan we are instituting here. Oregon PUC also cites a critique of a later study by I. Vogelsang. According to Oregon PUC, the critique, by D. Sappington, demonstrates that there are questions about the benefits of incentive regulation. We find that Sappington's criticisms apply to a price cap plan that would adjust an individual company's price cap in any time period based on its costs in the previous time period. Under such a plan, the company could

methodologies with features not unlike our proposal for incentive regulation.[181] Banded rate plans, streamlined review, as well as rate "freezes" dominate the state regulatory landscape. Our Further Notice, for example, described in detail the rate moratorium plan currently in effect in New York State for New York Telephone.[182] We stated that the sheer number of incentive-based experiments currently under way in the states is testimony to the limitations of rate of return.[183]

---

possibly increase its costs next year by padding its costs this year. Our plan permits no such adjustment to the cap; the exogenous costs we adjust for are outside a carrier's control.

181 I n its comments, AT&T identifies 17 states that have ended rate of return regulation for it: Florida, Georgia, Idaho, Illinois, Maryland (continuing to employ an earnings margin), Minnesota, Nebraska, New Jersey, Nevada, Oklahoma, Oregon, Pennsylvania (continuing to employ an operating ratio), South Carolina, South Dakota, Virginia, Washington, and West Virginia. AT&T Comments at 2, n.**. On October 26, 1988, Colorado also moved to an incentive-based system of regulation for most AT&T services, including MTS and WATS. See Application of AT&T Communications of the Mountain States, Inc. for Relaxed Regulation of Certain Emerging Competitive Telecommunications Services, Decision No.C88-1467, October 26, 1988. On January 24, 1989, the Iowa Public Service Commission announced a decision deregulating all of AT&T's services except operator-assisted MTS. New York has replaced traditional rate of return with an incentive-based regulatory plan governing AT&T's intrastate rates.

182 Further Notice, 3 FCC Rcd at 3236-40 (paras. 71-81). Similar plans have been introduced for LECs in Connecticut, Alabama, Kentucky, Wisconsin, and Florida.

183 In addition to the 20 states that no longer regulate AT&T pursuant to rate of return methods, 16 other states have introduced reduced rate of return regulation for AT&T and have granted increased pricing flexibility: Alabama, Arizona, California, Indiana, Kansas, Kentucky (MTS only), Louisiana (MTS only), Michigan, Mississippi, Missouri, Montana, North Carolina, Ohio, Tennessee, Texas, and Wisconsin. As a result, 36 of the 42 states for which AT&T provides intrastate toll services have reformed or abandoned the form of regulation this Commission currently employs in regulating AT&T. States have also begun to introduce reform in their regulation of LECs. In addition to those states employing a profit-sharing mechanism like New York's, states such as Ohio, Maryland, New Jersey, Vermont, Idaho, and West Virginia have introduced additional flexibility or streamlining into their rate of return regulation of LECs.

109. For example, of those states that have moved away from rate of return regulation for AT&T, most provide for pricing flexibility[184] with reduced notice periods for rate changes.[185] Some states do not attempt to measure AT&T's intrastate profitability under the various regulatory reforms,[186] although some require financial reporting that reflects total

---

184 Full pricing flexibility for AT&T is provided in Virginia, Oklahoma (on an interim basis), Idaho, Iowa, Illinois, West Virginia, Maryland, Minnesota, Nebraska, Oregon, Pennsylvania, South Dakota, and Washington. Prices may move within a specified range in California, Indiana, Georgia, Arizona, Missouri, Kansas, Mississippi, Montana, Nevada, North Carolina, Ohio, Tennessee, New York, South Carolina, Florida, and Colorado. New Jersey capped existing MTS rates for one year during 1988, after relaxing rate of return regulation in 1985. In addition to New Jersey, six other states permit partial pricing flexibility for AT&T's MTS or WATS services: Alabama, Michigan, Texas, Wisconsin, Kentucky, and Louisiana.

185 E.g., Virginia (10 days' notice for all services); Oregon (30 days' notice for increases, one day for decreases); Nevada (10 days' notice if within a specified range); Oklahoma (30 days' notice); Pennsylvania (30 days' notice); Illinois (30 days' notice for increases, one day for decreases); West Virginia (14 days' notice); Maryland (14 days' notice); Nebraska (one day to reduce rates up to 50 percent, one day to increase access or billing charges); South Carolina (14 days' notice for rates below a ceiling); Minnesota (30 days' notice for increases, 10 days for decreases); Washington (10 days' notice); New Jersey (14 days' notice for increases below a ceiling, 5 days' notice for decreases); South Dakota (20 days' notice); Idaho (10 days' notice); Georgia (14 days' notice for rates below a ceiling); Florida (30 days' notice for rates within a specified zone); Colorado (14 days' notice for MTS within a specified zone and 14 days' notice for WATS/800 and Megacom).

186 Virginia, Oregon, Nevada, Oklahoma, Illinois, West Virginia, Nebraska, South Carolina, Washington, New Jersey, Idaho, and Georgia do not track intrastate profits. But see Pennsylvania (reviews AT&T's operating ratio and applies a comparable earnings test); Maryland (reviews operating margin quarterly); and Florida (reviews quarterly rate of return reports).

company earnings[187] or other monitoring of AT&T performance.[188] These regulatory reforms for AT&T at the state level began shortly after divestiture and continue today.[189] One study of states that have applied an incentive-type approach to the regulation of AT&T's Message Telecommunications Service

---

187 Virginia (annual report and quarterly revenue reports); Nevada (semi-annual report on intrastate revenues, annual report, 10K report to SEC); Oklahoma (annual report); Pennsylvania (annual report, abbreviated income statement); Illinois (Form M annual report, total telecommunications plant in service and total operating revenues); West Virginia (annual report); Maryland (income statement for intrastate long distance, quarterly rate base reports, quarterly analysis of margin, total minutes of use and total revenue on a quarterly basis); Nebraska (annual report); South Carolina (quarterly surveillance reports, annual reports, Form M for AT&T of the Southern States); Washington (annual financial and affiliated interest reports); Florida (quarterly surveillance reports, annual reports, analysis of margin between rate ceilings and rate levels); Colorado (annual report).

188 Virginia (monitors price levels financial condition, complaints, held orders for other IXCs, competitive activities); Nevada; Nebraska (annual reports from commission to legislature); Minnesota (commission may require information on revenues, expenses, costs, and investments); Washington (annual reports to the legislature); Georgia (maintain records in accordance with the USOA, and furnish reports as required by the Commission); Florida (two-year trial to end with review of number of factors); Colorado (quarterly reporting of revnues, expenses, investment, numbers of customers, calls, minutes of use, trunks, rate of growth or estimate of growth, records of customers who switch services).

189 Virginia adopted its decision to abandon rate of return for AT&T in August 1984, followed by Oregon in December 1984. Nevada, Oklahoma, and Pennsylvania followed suit in 1985. In 1986, the states of Illinois, West Virginia, and Maryland decided to abandon rate of return for AT&T, followed by Nebraska, South Carolina, Minnesota, Washington, and New Jersey (for MTS) in 1987. In 1988, South Dakota, Idaho, Georgia, Florida, and Colorado moved away from rate of return regulation for AT&T. Iowa adopted its decision to abandon rate of return in 1989.

(MTS) rates demonstrated that prices are on average between 7 and 10 percent lower in reform states than in those that use traditional rate of return.[190] Furthermore, many states are actively pursuing reform of their regulation of the LECs.[191]

110. We have also closely evaluated the experience of the United Kingdom in regulating British Telecom under incentive regulation.[192] In the Further Notice, we found that the weighted prices for British Telecom's services offered under incentive regulation increased by 5.5 percent over a time period when the United Kingdom's overall inflation rate rose by 20.1 percent.[193] Since the Further Notice was released, our regulatory counterparts in the United Kingdom, the Office of Telecommunications (Oftel), have completed their initial review of their incentive-based system.[194] Regulators found that British Telecom had managed to increase its productivity under the plan to such a degree that Oftel proposed to retain the price cap system. In addition, Oftel found productivity gains were greater than expected, and amended the formula that dictates price limits by increasing the downward pressure on

---

190 A. Mathios & R. Rogers, The Impact of Alternative Forms of State Regulation of AT&T on Direct Dial Long Distance Telephone Rates, Federal Trade Commission, Bureau of Economics, Working Paper Series No. 159 (Dec. 1987).

191 Those states currently studying reform include: Illinois, Iowa, Indiana, the District of Columbia, Massachusetts, Virginia, Florida, California, Nevada, Oregon, and Washington. Vermont decided on December 30, 1988 to remove rate of return regulation from New England Telephone's regulated services, and to freeze rates at existing levels. Investigation of the Proposed Modified Vermont Telecommunications Agreement, Docket No. 5293, Dec. 30, 1988. The Michigan Commission on February 7, 1989 decided to move forward with a proceeding that would permit Michigan Bell earnings flexibility within a specified range. Application of Michigan Bell Telephone Company for Authority to Implement a Trial Plan for Modified Regulation, Case No. U-8987, Feb. 7, 1989.

192 Further Notice, 3 FCC Rcd at 3229-40 (paras. 57-81).

193 Id. at 3239 (para. 80).

194 "The Control of British Telecom's Prices," Oftel Statement, released July 7, 1988.

rates.[195] British consumers will therefore be the direct beneficiaries of British Telecom's efficiency gains.

111. In addition to finding that incentive regulation is capable of eliminating, and even reversing, several significant flaws inherent in rate of return, we also find that incentive regulation is better for consumers. By acting directly on a carrier's costs of providing service, and by increasing a carrier's willingness to innovate, incentive regulation means that telecommunications consumers can look forward to low cost and innovative services that the current regulatory structure would discourage. Furthermore, as will be discussed as part of the implementation sections of this Order, we are introducing substantial ratepayer protections to ensure that consumers will be better off as a group, and in particular, that residential ratepayers receive benefits from our plan. Features such as the Consumer Productivity Dividend (CPD), review and adjustment of the productivity factor beginning three years from the date of inception, and careful attention to the design of baskets and bands ensures that consumers will benefit from an incentive system.

112. We reject arguments that carriers will be the only party to benefit from incentive regulation. Under incentive regulation, both carriers and ratepayers will benefit. Through ratepayer protections that guarantee that consumers share in carrier efficiency gains, consumers will see price reductions that would not have occurred in a rate of return setting. The elimination of inefficiencies through use of the CPD ensures that gains accrue to ratepayers first and foremost, before carriers obtain any benefits of increased earnings.[196]

113. We conclude that incentive regulation is better suited to the task of regulating certain dominant carriers than is rate of return.[197] By

---

195 Id. at 20 (proposing to change the productivity offset from 3 percent to 4.5 percent).

196 The formula we adopt for AT&T and propose for the LECs, infra, ensures that 0.5 percent of productivity a carrier gains over its historical productivity must first be applied to decrease aggregate rates, before a carrier can reap any profit from its increased productivity. See Section III.C.1.c and Section IV.C.1, infra.

197 In the Further Notice, we stated that, for the purposes of this proceeding, the term "dominant carrier" encompasses AT&T and the local exchange carriers. 3 FCC Rcd at 3203-03 (para. 8 n.13). We concluded that the revision of our rules concerning rate regulation of Comsat raised issues that could not be resolved in this docket. In addition, we concluded that, should AT&T elect price cap regulation, Alascom would be included under price cap regulation with regard to most of its facilities, because Alascom and AT&T

employing carriers' natural incentives to generate profit, we can devise a system of regulation that functions far more smoothly than the existing system. Our judgment on this issue has been informed by our lengthy experience with rate of return, and by the successful incentive-based

---

presently concur in each other's MTS and WATS tariffs. Id.

Comsat argues that there is no valid reason to exclude it from price cap regulation, and that its obligation to share in the costs of Intelsat should not render it ineligible. Comsat Comments at 4-5. Comsat argues that Intelsat is owned by and responsive to its signatories, and does not constitute a pooling arrangement of the type we found unsuitable for price caps in the Further Notice. Id. at 8-9. Comsat states that both Intelsat and Comsat have strong incentives to increase efficiency. Id. at 5. In addition, Comsat contends that price cap regulation would alleviate heavy administrative burdens for both this Commission and for Comsat. Id. at 10. We reiterate the conclusion of the Further Notice: alternative regulation for Comsat raises issues that cannot be resolved in this proceeding. Comsat has a statutory obligation to participate in a global communications network, and has been designated as the United States Signatory to the Agreement Relating to the International Telecommunications Satellite Organization "Intelsat" 23 U.S.T. 3813, T.I.A.S. 7532 (1971) (hereinafter Intelsat Operating Agreement). See also Section 102 of the Communications Satellite Act of 1962, 47 U.S.C. § 701. As a signatory to Intelsat, Comsat is obligated to share in the costs of Intelsat. Intelsat Operating Agreement, Article II. Thus, regulatory reform for dominant carriers cannot be mechanically applied to Comsat, whose corporate mission is given shape by federal legislation and treaty.

Alascom agrees that the operation of the Alascom-AT&T joint service agreement will necessarily include Alascom under price cap regulation, but only to the extent of its MTS and WATS services. Alascom argues that its private line services should also be subject to price cap regulation. Alascom Reply at 6. We conclude that it would not be wise to apply price cap regulation to Alascom's private line services at this time. The productivity factor in the price cap index is developed on a nationwide interstate basis. Alascom's contention that we should apply the price cap formula to its private line services alone raises the issue of whether the productivity number calculated on a nationwide interstate basis for AT&T in this Order would result in just and reasonable rates if applied in the context of private line services in the Alaska market. Alascom's argument therefore raises questions that cannot be resolved at this stage of the proceeding.

Finally, Hawaii raises the issue of price cap treatment for GTE Hawaiian's provision of international services. Hawaii Comments at 20-23. The issues raised by Hawaii regarding GTE Hawaiian's operations will be addressed as part of our discussion concerning the implementation of incentive

regulatory systems currently in use in the various states, as well as Great Britain. Furthermore, we believe that the potential pitfalls of incentive regulation identified by commenters can be avoided with careful attention to implementation.

114. Our determination that incentive regulation is superior to rate of return as a matter of policy does not end our task. Rather, it marks the beginning of the work of transforming incentive principles into a system of policies and rules that can be administered effectively on a day-to-day basis. We are not unmindful of the pitfalls identified by some commenters of the harmful effects that might attend the introduction of incentive regulation if such a system is not implemented properly, particularly as these comments relate to implementation of incentive regulation for local exchange carriers. Although any final judgment about incentive regulation depends in large measure on the specifics of implementation, we believe the pitfalls discussed in the record can be avoided. In the following section, we consider in detail the arguments raised concerning incentive-based regulation for AT&T. In the section thereafter, we consider implementation issues relating to incentive regulation for local exchange carriers.

III. INCENTIVE REGULATION FOR AT&T

115. In the previous section, we sketched the broad outlines of a plan to reform our regulation of dominant carriers, and concluded that the approach we outlined, which we have termed "incentive regulation," is superior to rate of return as a method for curbing the market power of dominant carriers. In that section, we addressed the general concerns of a number of parties about our comparison of rate of return and incentive regulation as a means of regulating dominant carriers. In this section, we address the specific concerns that have been raised about applying incentive regulation to AT&T.[198] We also set forth in detail the mechanisms we will employ in regulating AT&T under an incentive-based system that we call "price cap regulation."[199]

---

regulation for the LECs in Section IV.C.2.b, infra.

198 In resolving implementation issues for AT&T, we have addressed arguments that are directed to AT&T, or that do not logically and explicitly exclude AT&T. LEC-specific issues are addressed in the portion of this Order that constitutes the Second Further Notice of Proposed Rulemaking.

199 The final rules implementing price cap regulation for AT&T are contained in Appendix B.

A. Incentive Regulation as Applied to AT&T

116. An analysis of incentive regulation would be incomplete without an evaluation of the entire range of possible incentives that a price cap system would invoke, both positive and negative. Commenters argue that price cap regulation will create two incentives that will be harmful to ratepayers: (1) in an effort to generate short term profits, AT&T will underinvest in or fail to maintain its network, or both; and (2) so long as at least some states remain with rate of return, AT&T will have an incentive to shift costs to the intrastate jurisdiction.[200] In addition, parties have raised other issues that involve the application of incentive theory to AT&T. Virtually all of the comments offered on these issues begin with an implicit or explicit view of the degree to which AT&T faces competition in the marketplace. We shall therefore explore the subject of competition first, in an effort to draw some general observations about competition for AT&T services and the relationship of competition to incentive regulation.

1. Interaction of Competition and Regulation

a. Summary of Further Notice

117. The Further Notice reached two fundamental conclusions about the relationship of competition to price cap regulation. First, we tentatively found that a complementary relationship exists between price cap regulation and competition. Second, we tentatively found that competition is a relevant consideration in making decisions about how to implement price cap regulation.[201] In reaching these two conclusions, we tentatively found that the natural tension that exists between competition and rate of return, which surfaces in the practice of cost shifting, can be avoided through the use of incentive regulation, which blunts the incentives to shift costs from more competitive services to less competitive services. We also tentatively found that price caps, by eliminating the need to impose fully distributed cost allocation (FDC) methodologies on carrier rates, would minimize distortions to the competitive process that could occur under FDC-based pricing.[202] We

---

200 We discuss these issues here, rather than in the earlier section comparing rate of return with incentive regulation, because we do not believe either of these issues is a fatal flaw of incentive regulation, but rather can be addressed through application of regulatory procedures built into our price cap system. See Section II.B, supra. Morover, in the case of AT&T, we believe that the existence of interexchange competition influences our response to these issues.

201 Further Notice, 3 FCC Rcd at 3267 (para. 138).

202 Id. at 3267-68 (para. 141).

also tentatively decided that the discipline that competition brings to carrier pricing policies can be incorporated into a regulatory program to ensure that rates remain within the zone of reasonableness.[203]

118. We noted that AT&T's share of the interstate market is significantly less than 100 percent and continues to decline. We cited statistics we had previously gathered on AT&T's share of switched access minutes purchased from the LECs, as well as the number of interexchange carriers purchasing switched access and premium access, to demonstrate the scope of competition faced by AT&T.[204] We also noted that several of AT&T's largest competitors serve nearly all domestic jurisdictions, and that facilities-based competition to AT&T has grown substantially.[205]

b. Pleadings

119. A few parties explicitly agree with our view that price cap regulation is a more desirable regulatory mechanism than rate of return in an environment of emerging competition.[206] US Sprint argues that the advent of competition in the interexchange market has substantially exacerbated the concerns about cross-subsidization among rate of return regulated services.[207] Cable & Wireless and the Executive Agencies argue that price caps is a sensible transitional mechanism for AT&T that can eventually be left behind once the interexchange market is fully competitive.[208] The CWA agrees that price cap regulation is a mechanism complementary to competition, arguing that an incentive-based system will banish unfair competition generated by AT&T's

---

203 Id. at 3268 (para. 142).

204 Id. at 3268-69 (paras.143-44).

205 Id. at 3269-70 (paras. 145-46).

206 Alltel Comments at 1-2; US Sprint Comments at 5; US West Comments at 7.

207 US Sprint Comments at 3. See also CCIA Comments at 3.

208 Cable & Wireless Comments at 6, 21; Executive Agencies Comments at 6.

competitors, whose tariffs are forborne.[209] Finally, NTN states that the existence of competition for AT&T's services can substitute for Commission action in the event price cap regulation or its administration is flawed.[210]

120. Many of the pleadings we received on this issue focus on the nature of the competition faced by AT&T. Several parties argue that while the number of AT&T's competitors is large, the amount of competition faced by AT&T is small.[211] These parties nevertheless argue that AT&T will continue to be faced with increasing competitive pressures.[212] Furthermore, commenters allege that in addition to being relatively small in size, competition for the services provided by AT&T is uneven. Cable & Wireless argues that problems, such as the absence of widespread facilities-based competition and the advent of strategic pricing, continue to plague the interexchange industry, preventing the market from becoming fully competitive.[213] MCI argues that the different levels of competition for various AT&T services create incentives to cross-subsidize, and that barriers to entry are only now beginning to fall.[214] Some parties argue that competition is so fragile that special care needs to be taken to avoid predatory pricing and to obtain consumer benefits.[215] Others argue that the correct model of the present-day

---

209 CWA Comments at 1-3. Contra Michigan PSC Comments at 5 (arguing that consumer benefits can only be increased by fostering competition, not by changing regulation, and that potential competitors rely on rate of return to determine the existing level of price competition).

210 NTN Comments at 31 (arguing that it is therefore important not to endanger competition).

211 New Hampshire PUC Comments at 4; US Sprint Comments at 2; MCI Comments at 2, 56; ALC Comments at 7; NTN Comments at 7.

212 See, e.g., US Sprint Comments at 2; MCI Comments at 2, 56.

213 Cable & Wireless Comments at 22.

214 MCI Comments at 56-58. See IDCMA Comments at 39-40; NARUC Reply, App. D; ALC Comments at 7 n.6; Comptel Comments at 9-10 (arguing that remaining barriers to entry should be this Commission's first priority). See also Wisconsin PSC Comments at 5 (describing Wisconsin's regulation of AT&T as focusing principally on MTS, and permitting the state commission to rely on competition to "set" the rates of other AT&T services).

215 Missouri PSC Comments at 6. See also MCI Comments at 59, 62 (arguing that this Commission should fully enforce our tariffing requirements and resale policies with respect to AT&T, as well as resolve the custom tariff issues presented in AT&T's Tariff 12 and Tariff 15 offerings, before adopting a price cap mechanism); PRTC Comments at 3.

interexchange industry is that of an oligopoly, with AT&T as the price leader, and that price competition does not exist.[216]

121. Some parties are less willing to categorize the current or future state of competition for AT&T services. The New Hampshire PUC states that the interexchange market is evolving from monopoly to an "increasingly pluralistic, interconnected, and interdependent set of service providers."[217] The New Hampshire PUC argues that it is not clear how AT&T's competition will continue to evolve.[218] Nevertheless, the New Hampshire PUC does not appear to view a degree of uncertainty about the future as a reason to refrain from price cap regulation for AT&T.[219] NARUC, although not linking its analysis to the level of competition, also states that this Commission might proceed with an AT&T price cap plan on an experimental basis.[220]

122. Other parties skirmish over whether sufficient competition exists to warrant deregulation of some or all of AT&T's services. AT&T argues that competitors have made substantial inroads in the market for large business users, reducing AT&T's market share of its outward domestic business segment from 77 percent in 1984 to 60 percent at the end of 1987.[221] AT&T also states that its share of the residential market has dropped over the same period from 80 percent to 72 percent.[222] AT&T further argues that it should receive

---

216 Colorado OCC Comments at 4; Executive Agencies Comments at 6; Bell Atlantic Comments at 19 n.39.

217 New Hampshire PUC Comments at 4.

218 Id. at 13-14.

219 Id. at 7 (stating that price caps may work in the interstate toll market).

220 NARUC Reply at 4-6.

221 AT&T Comments at 4-5.

222 Id. at 5 n.***. Other commenters argue that AT&T's market share is slightly higher than AT&T reports. NTN, citing a survey of users published in a trade journal, states that AT&T carries 64 percent of business traffic and 76 percent of the private line data traffic. NTN Reply at 14-15. ALC, citing a different trade publication, argues that AT&T continues to serve over 87 percent of the interexchange customer base, while accounting for 70 percent of all interexchange revenues. ALC Comments at 7. MCI, citing press reports of AT&T's own statements, argues that AT&T's overall share of the interexchange market is 80 percent. IDCMA, citing this Commission's data, states that AT&T carries 73 percent of premium switched interstate traffic,

the same forebearance treatment of its tariffs as its competitors do.[223] Several other parties support at least partial deregulation of AT&T's services.[224] Other parties strongly oppose deregulation on the basis that insufficient evidence has been amassed to permit this Commission to reverse our previous findings that AT&T retains market power.[225]

123. Parties have also commented on the relationship between competition for AT&T services and price cap regulation. US Sprint argues that with respect to AT&T, the only way out of the regulatory "quagmire" engendered by fully distributed costing and other features associated with rate of return, is to move to a price cap regulatory system.[226] According to US Sprint, the use of rate of return enables AT&T to engage in cross-subsidization that ultimately harms competition.[227] Of course, parties are also concerned that unless price cap regulation is properly designed, incentives to engage in cross-subsidization will continue to exist.[228] Furthermore, AT&T states that price cap regulation will provide it with the flexibility necessary to price its services to meet competition.[229]

---

and 70 percent of all interstate minutes. IDCMA also states that AT&T's share of private line service is higher, and could be as much as 90 to 94 percent. IDCMA Comments at 34-36.

223 Id. at 3-7; AT&T Reply at 2-3.

224 NTIA Comments at 2 (arguing that even price cap regulation is not needed if there is effective competition); Nevada Comments at 3 (stating that it previously found the interexchange market competitive and deregulated AT&T's intrastate operations); US Sprint Comments at 10-13 (price cap regulation ought to apply only to AT&T's noncompetitive services).

225 IDCMA Comments at 33-37; Indiana UCC Comments at 20; ICC Reply at 5-8; NTN Reply at 12-16.

226 US Sprint Comments at 6-8.

227 Id. at 2-6.

228 See, e.g., Cable & Wireless Comments at 23-25; NTN Reply at 25; US Sprint Comments at 8.

229 AT&T Reply at 2. See also Ameritech Reply at 16-22.

124. Other commenters are less convinced that price caps are necessary to address competitive issues. PRTC states that for AT&T, efficiency incentives are not necessary since competition already drives AT&T to become more efficient.[230] MCI and ALC would prefer that we turn our attention to enforcing market rules instead of promulgating price caps.[231] Others state that because AT&T remains dominant, the pricing flexibility provided for in our proposal will not result in a set of efficient prices.[232] Comptel argues that the pricing flexibility component of our proposal may well risk the development of competition in the interstate market, unless flexibility is minimal.[233] Finally, the Connecticut OCC argues that rate of return has resulted in AT&T's lowering its rates by over $1 billion since 1984, and that we ought not to discard existing regulation so quickly.[234]

c. Discussion

125. There are three observations about competition that we believe are important to make in connection with our consideration of price caps for AT&T. First, we find that in an environment that is in transition from monopoly to full competition, rate of return regulation has become so dysfunctional that incentive regulation represents a substantial and needed improvement over existing regulation. Second, the presence of competition for many of AT&T's services means that regulation, in whatever form, is not the only check on AT&T's ability to set its prices. Third, we affirm our view that competition and incentive regulation are complementary, and that competition must be a factor in shaping the form of incentive regulation we will use to regulate AT&T.

126. We have previously discussed, in our comparison of rate of return and incentive regulation, our concerns that rate of return has an inherent tendency to foster cross-subsidization, and that the use of fully distributed cost (FDC) allocation requirements results in a set of prices that produces a consumer welfare loss.[235] This Commission, recognizing that these flaws exist, has for many years pursued a policy of fostering competition in the

---

230 PRTC Comments at 5. But see Comptel Comments at 41 (arguing that price cap systems in two states have resulted in AT&T's earning excessive profits).

231 MCI Comments at 56-62; ALC Comments at 29-34.

232 Indiana UCC Comments at 5-6; Colorado OCC Comments at 4.

233 Comptel Comments at 19-20.

234 Connecticut OCC Comments at 2-3.

235 See Section II.B, supra.

market for common carrier services.[236] However, when a monopoly common carrier begins to face competition, the flaws we have cited in rate of return become major obstacles to the development of full competition.

127. The primary example of this phenomenon is the tendency of rate of return to encourage cross-subsidization. Since competition does not develop evenly across all services, the former monopolist possesses varying degrees of market power over its services. If competition is driving the price of one service down, the former monopolist may attempt to engage in anticompetitive pricing practices in an effort to drive its competitors out of the market or signal to them that they are not free to price their services below a certain level. Under rate of return, the former monopolist may attempt to undercut its competitors by migrating its costs to a less competitive service, thereby securing a higher price for the less competitive service.[237]

128. Fully distributed cost allocation requirements also present difficulties in a competitive environment. If FDC allocations result in rates that exceed those that would be in effect under competition, competitors may engage in cream-skimming. If FDC allocations result in prices that are too low, potential competitors may be discouraged from entering the market. Moreover, in all cases FDC-based pricing produces distortions that would not exist if prices were set by competitive economic considerations, i.e., marginal cost, or in response to market demands.

129. Incentive regulation, and specifically price caps, alleviates these obstacles to the development of full competition. Since price cap regulation stimulates a carrier to provide services efficiently, it minimizes the incentive that exists under rate of return to shift costs in order to generate profits. Under price caps, shifting costs to a less competitive activity

---

236 See, e.g., Regulatory Policies Concerning Resale and Shared Use of Common Carrier Domestic Public Switched Network Services, 83 FCC 2d 167 (1980), recon. denied, 86 FCC 2d 820 (1981); Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, First Report and Order, 85 FCC 2d 1 (1980); Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 FCC 2d 958 (1986), clarified on recon. 2 FCC Rcd 3035 (1987).

237 The same incentive to cross-subsidize also exists with respect to the carrier's nonregulated activities. Nonregulated activities, which fall outside our Title II jurisdiction, tend to be competitive, and a carrier subject to rate of return has an incentive to shift costs away from such services to its less competitive, rate of return regulated activities. See Further Notice, 3 FCC Rcd at 3224 (para. 48).

would result in that activity earning less profit.[238] As a result, price cap regulation is a far better regulatory system to employ in an environment in transition to full competition than is rate of return.[239]

130. Second, the existence of competition for many of AT&T's services means that the regulatory method employed by this Commission is not the sole agent acting on AT&T's ability to set prices. Even in an environment in which AT&T remains dominant, the increased competitive activity for many of its services means that AT&T may not be able to raise prices without inviting further competitive entry. The existence of competition for AT&T's services seems to provide additional reassurance to parties that price cap regulation will not result in unjust and unreasonable rates. Many parties that are otherwise troubled by employing price caps for dominant carriers generally state that applying a price cap approach to AT&T would be acceptable.[240]

131. Finally, we affirm our view that price cap regulation ought to be designed with one eye toward the competitive realities of the interstate toll market. As we stated in the Further Notice, the discipline that competition

---

238 Of course, the potential for cross-subsidization exists if a carrier is given uncontrolled pricing flexibility. We have addressed this concern by limiting AT&T's pricing flexibility and, more fundamentally, by designing a system of baskets that are intended to reduce opportunities for cross-subsidization. See Section III.C.2.b., infra.

239 While commenters generally discussed the interaction of incentive regulation and innovation, no commenters specifically addressed the effect price cap regulation would have on AT&T's incentives to innovate. We believe that the price cap system we propose is much better suited to prompting innovation in an environment of emerging competition. As we stated in the previous section, incentive regulation provides greater incentives for useful innovation than does rate of return. Thus, the regulatory system we adopt for AT&T, and the emerging competive environment that AT&T faces, can work together to spur innovative offerings that will expand the range of consumer choice and lower costs.

240 API Comments at 2; Networks Comments at 6; TCA Comments at 3, 5; Colorado OCC Comments at 31; Executive Agencies Comments at 4; Cable & Wireless Comments at 2; Missouri PSC Comments at 2; New Hampshire PUC Comments at 7; Ohio PUC Comments at 1-2; Virginia Comments at 7; ICC Comments at 2; NARUC Reply at 4-6; NY Enertel Reply at 2; Texas PUC Reply at 6. See also California PUC Comments at 1 (incorporating the comments they filed leading up to the Further Notice, supporting alternative regulation for AT&T). Of course, many of these commenters recommend changes in the specific methodology we proposed. Those filing informal comments in this proceeding also favored regulatory reform for AT&T.

brings to a carrier's prices can be employed in the design of a price cap system to ensure that rates are just, reasonable, and non-discriminatory.[241]

132. In the Further Notice, we discussed the state of competition in the interstate toll market. The observations we made there are as true today as they were at the time the Further Notice was released. While some of the data we cited have been updated,[242] no dramatic changes have occurred in the intervening period that would render the market substantially more, or less, competitive. Record evidence indicates that AT&T's market share is considerably less than 100 percent and is steadily declining.[243] The number of companies that provide interstate toll service in competition with AT&T is indicative of a marketplace that is steadily yielding to competitive pressures.[244] Furthermore, four of AT&T's competitors have constructed their own fiber optic networks, providing substantial facilities-based competition to AT&T.[245]

---

241 In Section III.C.2, infra, we discuss how some of the barriers to the development of full competition for AT&T's services have led us to modify our proposal for AT&T's baskets and bands.

242 See "Report on Long Distance Carriers," Industry Analysis Division, FCC, Oct. 6, 1988.

243 The Further Notice cited a previously-released report demonstrating that AT&T's share of switched access minutes declined from 84.2 percent in mid-1984 to 70 percent by the end of 1987. In addition, the report found that AT&T's share of "premium" minutes (those subject to equal access requirements) fell from nearly 99 percent in mid-1984 to slightly more than 70 percent. Further Notice, 3 FCC Rcd at 3268 (para. 143).

244 Our most recent data collected show that there are 248 carriers purchasing equal access at various locations around the Nation. While some of these carriers purchase equal access in only one jurisdiction, calls may be completed nationwide through the resale of AT&T's services. Three carriers, in addition to AT&T, offer originating equal access service on a nationwide basis, or nearly on a nationwide basis -- US Sprint and MCI serve all of the 48 states for which we have data, while Western Union Telegraph serves 46 states. Four other carriers serve 25 or more states. Finally, there are a total of 519 companies purchasing switched access of different types from the Bell Operating Companies. "Report on Long Distance Carriers," Industry Analysis Division, FCC, Oct. 6, 1988.

245 See "Fiber Deployment Update: End of Year 1987," Industry Analysis Division, FCC, Jan. 1988, at 2. As we stated in the Further Notice, the capacity of two of the rival fiber optic networks appears to be sufficient to accommodate all domestic interLATA traffic. Further Notice, 3 FCC Rcd at 3269-70 (para. 146).

133. Although we are encouraged by the progress our pro-competitive policies have made, we are not proposing, let alone adopting, a policy of forbearance with respect to AT&T's services on the basis of the record before us. We agree that the evidence submitted in this proceeding demonstrates that AT&T faces competition in the market for interstate basic services. Due to the presence of some degree of competition, we are able to introduce policies permitting AT&T greater flexibility in setting its prices. However, as we have stated in the Further Notice, the purpose of this proceeding is to structure an effective regulatory system for dominant carriers, not to investigate the conditions necessary for forbearance.[246]

2. Effect on AT&T Service Quality

a. Summary of Further Notice

134. The Further Notice tentatively found that sufficient incentives to maintain and improve service quality would exist under a price cap system. We tentatively rejected arguments that carriers would degrade service quality in an attempt to generate short term profits. We tentatively found that cutting back on service quality would not necessarily increase profits.[247] We said that deterioriation in the network would ultimately mean that fewer calls are completed, and less revenue is collected. Due to the difficulties a carrier would have in assessing whether less maintenance or reinvestment would maximize profits, we tentatively found that carriers are much more likely to maintain a high quality network.[248] We also tentatively found that quality reductions tend to manifest themselves readily and invite swift response from regulators.[249] In addition, we stated that, for AT&T, any deterioration in its network is likely to result in customers migrating to its competitors.[250] We also stated that there was no evidence that rate of return was the cause of the existing high level of service quality, and therefore its departure does not compel a change in service quality policies.[251]

---

246 Reliance on bare market share data, as suggested by AT&T in its comments, reflects only one dimension of the analysis that must be brought to bear on a decision to take such an approach to the regulation of AT&T.

247 Further Notice, 3 FCC Rcd at 3265 (para. 134).

248 Id.

249 Id. at 3265-66 (para. 135).

250 Id.

251 Id. at 3266 (para. 136).

135. We also tentatively found that our existing monitoring of service quality would serve as a check on a carrier's ability to degrade its network.[252] We reviewed our existing methods of monitoring service quality, and tentatively decided to maintain these under a price cap regime.[253] We stated that the application process under Section 214 of the Communications Act provides us with a flexible tool to identify and correct service quality concerns, and that we have used our powers under Section 214 to require AT&T to file semi-annual quality of service reports with us.[254] We also stated that we had the power to scrutinize technical standards contained in tariffs, as well as hear complaints about service quality through the complaint process under Section 208 of the Communications Act. In addition, we tentatively found that the National Security and Emergency Preparedness reports we receive provide further assurances that service quality will not deteriorate.[255]

b. Pleadings

136. Parties are sharply divided over the effect price cap regulation will have on AT&T service quality. Several parties argue that to be successful under a price cap regime, a carrier must provide high quality service and state-of-the-art technology to its customers.[256] Parties also argue that the cost savings produced by letting a network deteriorate will in the long term be dwarfed by the costs to rehabilitate it.[257] SWB argues that carriers will not sacrifice their reputations for excellent service quality simply as a result of a change in the regulatory system.[258] West states that decisions

---

252 Id.

253 Id. at 3455-59 (paras. 489-95).

254 Id. at 3456 (para. 491).

255 Id. at 3458 (para. 494).

256 AT&T Comments at 50; BellSouth Comments at 17; NYNEX Comments at 37; AT&T Reply at 20; Bell Atlantic Reply at 19-20; Bell Atlantic Comments at 5. See also BellSouth Reply at 14.

257 CCIA Comments at 12; AT&T Comments at 51; AT&T Reply at 21; Pactel Comments at 8. Cf. NARUC Reply at 21-22 (arguing that the danger of service quality deterioration is real, and ultimately costly).

258 SWB Comments at 36. SWB further argues that the danger of deterioration in service quality arises only if rates are confiscatory, which is not a danger as long as price cap regulation remains optional. SWB Comments at 36-37. See also US West Comments at 41.

to trim maintenance expenditures are usually made only if a carrier is required to cut back expenses pending a rate of return represcription, and would not be a factor in a price cap regime.[259]

137. AT&T and others argue that the existence of competition means that service quality will continue to be an important priority, especially since quality is a principal form of interfirm rivalry.[260] AT&T further argues that since competition operates to ensure a high quality network, all ratepayers will benefit because improvements to the network cannot be confined to one service or one geographic area.[261] Cable & Wireless states that there may be "some possibility" that competition would limit AT&T's incentives to cut costs under price caps.[262] The New York DPS also states that the existence of competition means quality is less likely to decrease.[263]

138. Other parties, however, are convinced that price cap regulation will cause AT&T to cut its costs through underinvesting in its network or by failing to maintain its network properly.[264] Illinois argues that price cap regulation may restrict innovation and therefore restrict service quality.[265] The Colorado OCC argues that price cap regulation means that service quality levels will deteriorate to the level desired by the average customer, rather than the high quality of service that exists today under rate of return.[266]

---

259 US West Comments at 32, 35-37.

260 AT&T Comments at 50-51; AT&T Reply at 4, 21; Pactel Comments at 9; Ameritech Reply at 10.

261 AT&T Reply at 21-23.

262 Cable & Wireless Comments at 18

263 New York DPS Comments at 36.

264 Arinc Comments at 4; Colorado OCC Comments at 18; Comptel Comments at 40; Connecticut OCC Comments at 13-14; IDCMA Comments at 3, 11-12, 25-26; Indiana UCC Comments at 8-9; IIA Comments at 6; ICA Comments, App. B (BRI Report) at 45-51; Michigan PSC Comments at 10-11; Missouri PSC Comments at 10; Ohio PUC Comments at 6; TCA Comments at 23-24; Florida's Citizens Reply at 10-11; Hawaii Reply at 3; IDCMA Reply at 7; NARUC Reply at 20; Ohio PUC Reply at 3; Texas PUC Reply at 8; UCC Reply at 6-7; Cable & Wireless Comments at 2; CFA Comments at 26; Hawaii Comments at 10-11.

265 Illinois Comments at 12. See also CFA Comments at 26; IDCMA Comments at 25-26.

266 Colorado OCC Comments at 18-19.

Arinc argues that service quality was disrupted as a result of the divestiture of the Bell Operating Companies from AT&T, and that service quality is only now returning to normal.[267] Comptel states that if service quality declines, this Commission will not be in a position to order necessary improvements.[268] In addition, other parties attribute current levels of service quality directly to the operation of rate of return regulation.[269]

139. NARUC, in a Discussion Paper entitled "Telephone Service Quality Under Price Caps,"[270] argues that our tentative conclusion that a carrier would be dissuaded from providing poorer quality service because it would receive less revenues is incorrect. According to NARUC, it is likely that a carrier will target quality-oriented cost reductions to those areas that will neither jeopardize revenues nor result in consumers seeking out competitive service offerings.[271] The NARUC report argues that this type of austerity program is not uncommon, and requires that regulators both adopt standards and monitor carrier performance. The NARUC report also disagrees with the tentative conclusions that quality declines manifest themselves readily, and that current monitoring by this Commission is effective.[272]

140. CFA argues that reliance on competitive forces to maintain the incentives necessary to stimulate quality would be incorrect because competition is "feeble."[273] Several parties agree, stating that a carrier's designation as "dominant" means we have previously decided that competitive

---

267 Arinc Comments at 4.

268 Comptel Comments at 42. The DC PSC further argues that once service quality degrades, it will be the state commissions that bear the brunt of the complaints. DC PSC Comments at 3. NARUC argues that the telephone industry could soon find itself in the same position as the airline industry with regard to quality of service issues. NARUC states that airline regulators recently were forced to devote a substantial amount of resources to monitoring air safety, but that the expenditure of additional regulatory resources has done little to affect quality of service positively. NARUC Reply at 17.

269 See, e.g., UCC Reply at 5; NARUC Reply at 17.

270 NARUC Reply at App. E.

271 Id. at 4.

272 Id. at 4-5.

273 CFA Comments at 27.

pressures are an insufficient replacement for regulation.[274] The Colorado OCC argues that, despite AT&T's statements about quality-based competition among interexchange carriers, advertisements touting quality service do not necessarily translate into actual quality in the network.[275] NARUC states that while a service quality cutback may reduce revenues, it is likely that the carrier will be highly selective about the services such cutbacks affect.[276] NARUC claims that AT&T is interested in providing substandard service at reduced rates in certain cases, leaving some services in technological "backwaters."[277] Several parties also argue that price cap regulation will result in poorer service quality to rural areas of the Nation.[278]

141. Several parties voice concern over the service quality experience of British Telecom under the United Kingdom's version of price cap regulation. These parties argue that quality of service problems recently experienced by British Telecom can be attributed to price cap regulation.[279] NARUC argues that, contrary to our price cap proposal, our regulatory counterpart in Great Britain, the Office of Telecommunications (Oftel), has made a real commitment to improving quality of service, both by commissioning service quality surveys and by imposing contractual liability on British Telecom if certain service standards are not met.[280]

142. British Telecom informs that the quality of service problems it has experienced stem not from the mode of regulation under which it operates, but from extraneous events such as a 1987 engineering strike and a particularly destructive storm that affected a large part of its service area.[281] In addition, British Telecom states that the privatization of

---

274 Connecticut OCC Comments at 13-14; Illinois Comments at 12-13; IDCMA Comments at 27; IDCMA Reply at 7-8.

275 Colorado OCC Comments at 19.

276 NARUC Reply at 21.

277 Id. at 20.

278 Arkansas PSC Comments at 5; Michigan PSC Comments at 11; Florida PSC Comments at 3. See also Wisconsin PSC Comments at 3 (areas not subject to heavy competition may suffer service quality disruptions).

279 CFA Comments at 26 n.*; Comptel Comments at 42 n.38; DC PSC Comments at 4; IDCMA Comments at 26 n.29; ICA Comments at 28 & App. B (BRI Report) at 46-47; CFA Reply at 6; UCC Reply at 5-6.

280 NARUC Reply at 18-19.

281 British Telecom Comments at 5-7. See also BellSouth Comments at 19;

Great Britain's economy in recent years has produced a rapid rise in demand for service and advanced technology.[282] In response to this demand, British Telecom states that it is investing heavily in its own network and upgrading its technology.[283] British Telecom and other parties therefore conclude that there is no connection between mode of regulation and service quality problems in the United Kingdom.[284]

143. Those parties that believe price cap regulation would lead to service quality degradation, argue that we should adopt service quality standards that AT&T would have to meet. Some parties favor adoption of minimum technical standards such as dial tone speed, noise level, percent of blocked calls, and response time for service maintenance.[285] Parties also argue that we impose some penalty for deterioration of service from present levels.[286] NARUC and others state that we should adopt NARUC's standards or use NARUC's standards as a model to develop our own rules.[287] New York DPS argues that we should set standards for installation and repair performance, transmission characteristics, and connectivity (percent of completed calls).[288] Ameritech

---

AT&T Reply at 22. BellSouth argues that these extraneous problems aside, British Telecom received generally favorable ratings for its service quality. BellSouth Reply at 16. But see NARUC Reply at 17-18.

282 British Telecom Comments at 5-6.

283 Id. at 7-8. British Telecom also states that it has agreed to accept contractual liability for its failure to meet specific service quality standards involving the repair and installation of customer lines. According to British Telecom, contractual liability is a much better system for ensuring that service intervals are met than would be the collection of service quality statistics. Id. at 3-4.

284 Id. at 3; AT&T Reply at 22; BellSouth Comments at 19. See also Ameritech Reply at 59-60 (finding that a price cap plan temporarily in effect in Michigan did not adversely affect Michigan Bell's quality of service indicators). But see Arinc Reply at 2 n.7 (arguing that British Telecom has not proved the absence of a cause and effect relationship).

285 CFA Comments at 27; DC PSC Comments at 8; IDCMA Comments at 51; TCA Comments at 25; NARUC Reply at 19; Ohio PUC Reply at 3.

286 CFA Comments at 27; DC PSC Comments at 8. See also ALC Comments at 27 (urging this Commission to specify enforcement standards).

287 NARUC Reply at 19; DC PSC Comments at 9; ICA Comments at 28-29; Michigan PSC Comments at 3.

288 New York DPS Comments at 35.

argues that if standards are set, care should be taken not to conflict with state requirements.[289]

144. Others state that our monitoring efforts must be improved.[290] Comptel argues that degradation of the network could be subtle and gradual and not susceptible to monitoring at its early stages.[291] ICA states that existing monitoring efforts are not designed to detect underinvestment in telecommunications plant.[292] New York DPS argues that we need to receive data on a monthly basis, and at a sufficiently detailed level to preclude carriers from hiding service quality problems in aggregate statistics.[293] Arinc states that we should tariff service intervals.[294] Several parties argue that we should also require third party testing of the network.[295] Two parties state that monitoring information should be available to the public, in the same way that the Federal Aviation Administration makes airline on-time information available.[296] CFA argues that, in addition, this Commission must measure and

---

289 Ameritech Reply at 59-63.

290 Arinc Comments at 4; DC PSC Comments at 3, 7; Florida PSC Comments at 3-4; Hawaii Comments at 11; Illinois Comments at 13; IIA Comments at 6; Michigan PSC Comments at 10; New York DPS Comments at 34, 37; Ohio PUC Comments at 6; Alabama PSC Comments at 5; ALC Comments at 27-28; TCA Comments at 25; DC PC Reply at 7; Hawaii Reply at 3; NARUC Reply at 19; Ohio PUC Reply at 3; Texas PUC Reply at 9; CFA Comments at 24, 26; Comptel Comments at 41; IDCMA Comments at 27; CFA Reply at 6-7; IDCMA Reply at 7. IDCMA, for example, argues that private line services are not currently subject to quality of service monitoring, and monitoring should be expanded to include these services if a price cap plan is adopted. IDCMA suggests several types of data this Commission could collect. IDCMA Comments at 30-31.

291 Comptel Comments at 42.

292 ICA Comments, App. B (BRI Report) at 74-75.

293 New York DPS Comments at 37. See also IDCMA Comments at 28; New Hampshire PUC Comments at 27. The New York DPS argues that where competition exists, data normally collected by carriers can be filed in lieu of a set of statistics dictated by regulators. New York DPS Comments at 35.

294 Arinc Comments at 5.

295 Michigan PSC Comments at 11; Missouri PSC Comments at 10; Florida's Citizens Reply at 11.

296 CFA Comments at 27-28; New York DPS Comments at 34.

police long term financial commitment of resources to prevent underinvestment.[297] Several parties also argue that we should work with the states to establish a monitoring program.[298] NARUC questions whether we have the resources to monitor service quality adequately.[299]

145. Other parties argue that we should establish a compensation system similar to that enforced against British Telecom.[300] Michigan PSC argues that our complaint processes will not deter carriers from lowering service quality, since they allege our record on responding to complaints is not strong.[301] The New York DPS argues that if we rely on competition to solve some of our service quality concerns, we must ensure that users can easily switch from one service provider to another.[302] Some parties argue that if we monitor AT&T's performance, we should also monitor that of its competitors.[303]

146. Carriers argue that existing monitoring programs are more than sufficient.[304] They also argue that service quality is subject to state monitoring plans, and that these will serve as an additional check on service quality.[305] Both US West and AT&T argue that this Commission should not

---

297 CFA Comments at 28.

298 Michigan PSC Comments at 12; Ohio PUC Reply at 4; NY EnerTel Reply at 8-9.

299 NARUC Reply at 22. See also Comptel Reply at 21 (arguing that it is difficult to determine if underinvestment is occurring).

300 Arinc Comments at 5; DC PSC Comments at 9 n.19; New York DPS Comments at 36; Arinc Reply at 1-3.

301 Michigan PSC Comments at 11.

302 New York DPS Comments at 35.

303 Ameritech Reply at 63-64; CFA Comments at 27; Florida PSC Comments at 3-4.

304 See, e.g., Ameritech Comments at 35, 45; Pactel Comments at 10-11; AT&T Comments at 51; SNET Comments at 25-26; AT&T Reply at 21-23. Ameritech states, however, that it would not object if a monitoring proceeding were initiated to obtain information on carrier service quality. Ameritech Comments at 46-47.

305 AT&T Reply at 23-24; Pactel Comments at 11. But see NARUC Reply, App. E at 2 (state standards are inconsistent and the monitoring plans in place focus on voice grade service).

collect additional information.[306] According to US West, some service quality deterioration would be easy for customers to detect and report to regulators.[307] In addition, AT&T argues that it has more than 50 quality assurance programs in place that ensure customer satisfaction.[308]

147. Parties also address the issue of whether our proposals for new and restructured services would tend to create service quality concerns. ICA argues that a carrier could degrade the quality of an existing service in order to force customers to migrate to a new service that would temporarily be offered outside of the cap constraints.[309] API states that we need to establish a specific penalty to address this practice.[310] AT&T, however, argues that a migration strategy is self-defeating, since a customer is just as likely to switch to a competitor's service as to move to AT&T's new service.[311] AT&T also argues that such a strategy is easily detectable by regulators.[312] Bell Atlantic argues that, under our price cap proposal, a diminution in service quality is likely to require the filing of a non-streamlined restructured tariff, and that carriers cannot unilaterally abandon service quality provisions in their tariffs.[313]

c. Discussion

148. No party appears to argue that the existing service quality provided on AT&T's network is substandard. In fact, most of the comments that request additional service quality protections begin their analysis from the position that we ought not to tolerate any decline in service quality from its present level. Thus, the principal question that presents itself for resolution is whether price cap regulation will cause the network to deteriorate, as AT&T pursues short term profits.

---

306 US West Comments at 40-41; AT&T Reply at 4.

307 US West Comments at 38.

308 AT&T Comments at 51.

309 ICA Comments at 31.

310 API Comments at 30-31.

311 AT&T Reply at 54 n.****.

312 Id.

313 Bell Atlantic Comments at 6.

149. We believe there are a number of constraints on AT&T's ability to degrade its quality of service under a price cap regime. Since price cap regulation compels AT&T to act like any other for-profit firm, a decision by AT&T to degrade its service quality would have to be based on a decision that such a strategy will not cause profits to decrease, a difficult judgment at best. In addition, AT&T would have to implement a deferred maintenance or underinvestment strategy in the face of monitoring at both the federal and state level, thereby inviting regulatory intervention if quality of service measures show a decline. Furthermore, since many parameters of service quality are contained in AT&T's tariffs, changes in these parameters would have to be made in the context of public, non-streamlined tariff proceedings. Finally, the competition that exists for AT&T's services provides substantial assurance that AT&T would not degrade its quality of service, since its customers may seek out alternative suppliers of long distance service. While we believe that these factors will prevent deterioration of AT&T's service quality, we also wish to emphasize that a decline in AT&T's service quality, manifested in an increased number of complaints about its service, or changes to technical standards contained in its tariffs, would certainly renew our interest in adopting additional service quality protections.

150. First, as we stated in the Further Notice, it is not immediately apparent that AT&T would view underinvestment or deferred maintenance as profit-maximizing behavior, either in the short term or the long term. Deferred maintenance would obviously lead to fewer available circuits, which means fewer messages are completed and less revenue is generated. Before embarking on a policy of deferred maintenance, AT&T would have to decide that it would save more in maintenance expenses than it would lose in revenues, a calculation fraught with complexities.[314]

151. Second, our existing monitoring efforts also provide a check against service quality degradation. As we discussed in the Further Notice, we currently receive service quality monitoring reports from AT&T on a semi-annual basis. In the past, those reports included statistics on switch performance, analog transmission between AT&T's switches, and a report on circuit availability from the terminating toll office to the called party's premises. On October 20, 1988, AT&T decided to amend its quality of service report to expand substantially the scope of the report to include measurement of digital transmissions on AT&T's network.[315] Thus, while the previous statistics measured individual pieces of AT&T's public switched network, AT&T's new report provides data that will reflect the customer's experience

---

314 See Further Notice, 3 FCC Rcd at 3265 (para. 134).

315 Letter from Robert K. Graves, AT&T, to Chief, Domestic Facilities Division, FCC, Oct. 20, 1988.

in using AT&T's network, i.e., from the originating toll office through the completion of the call.

152. AT&T's new report, titled "Outgoing Trunk Service Evaluation," measures both circuit availability and equipment performance, and like the reports it supersedes, is capable of differentiating between busy/do not answer signals and equipment-related blockages and failures. Most significantly, however, the new report is capable of measuring the quality of calls made over digital facilities, a rapidly-growing portion of AT&T's network.[316] AT&T also will retain its "Network Trunk Transmission Measurement Plan" to track the experience of calls transmitted over analog facilities.

153. In addition to these monitoring reports, which provide either a measure of AT&T's ability to meet service quality objectives or a measure of change in service quality performance, this Commission also collects data pursuant to annual facilities authorization requests. Information collected under this Section 214 process can serve as an indicator of whether AT&T is providing adequate transmission capacity on its network. The circuit utilization data collected in the Section 214 proceedings, together with a report of AT&T's construction plans and its demand forecasts, provides another indication that AT&T is committed to maintaining a high quality network. Data on gross plant additions that we have collected through our Form M requirements, and will continue to collect through our ARMIS reports, can also serve this purpose.[317]

154. The data we collect are meaningful and useful in detecting any general decline in the quality of service AT&T provides. To pinpoint local or sporadic service quality problems, we rely primarily on subscriber complaints. The complaint process both provides a forum for the resolution of particular service quality complaints and serves the broader and more important function of acting as a warning system of service quality deterioration. We affirm our tentative view expressed in the Further Notice that many manifestations of service quality decline are easily detectable by ratepayers in the form of blocked calls, poor transmission quality, or slow installation and repair service. Indeed, the private line provisioning problems AT&T experienced under rate of return after divestiture triggered many complaints to this Commission, with the result that we began obtaining

---

316 The information generated by the new report will be in the form of an index. The index measures changes to service quality from a base period of January to July 1988, and is initially set at a level of 100.

317 Elimination of FCC Form 901, Monthly Form Required from Telephone Companies, CC Docket No. 87-503, 3 FCC Rcd 6261 (1988) (adopting automated reporting, on a quarterly basis, for AT&T to replace the FCC Form 901).

provisioning reports from AT&T.[318] Furthermore, as suggested by some commenters, state quality of service monitoring can to some extent supplement our own monitoring efforts, and is especially helpful in drawing attention to more localized problems.

155. In addition, many performance standards are provided in AT&T's tariffs.[319] We are not streamlining our review of proposed revisions to tariff terms and conditions, including terms and conditions relating to quality standards. Therefore, any attempts to revise tariffs that result in a downgrading of service quality standards remain subject to 45 days' notice and the possibility of rejection or suspension and investigation to determine their lawfulness. In these cases, therefore, AT&T's attempts to deliberately degrade service quality would have to be made in the context of a public proceeding in which AT&T would have to justify its proposals.

156. Finally, those commenters that view AT&T as not subject to much competition, warn that service quality standards, or increased monitoring, are essential if we are to prevent AT&T from underinvesting or deferring maintenance on its network under price cap regulation. Those commenters that view AT&T as subject to significant competition, argue that marketplace pressures, coupled with existing service quality monitoring of AT&T, are sufficient to keep service quality high. In the previous section, we concluded that AT&T is in fact subject to a degree of competition, although it remains the dominant carrier of interstate toll messages. In the case of service quality, however, it is not the number of competitors that is relevant, but whether there is any facilities-based competition to AT&T's network. Only if rival networks are available to customers can competition be relied upon to help maintain service quality. There are currently four fiber optic networks providing facilities-based competition to AT&T. The fiber optic systems owned by MCI and US Sprint each appear to have sufficient capacity to accommodate all domestic interLATA traffic for the foreseeable future.[320] Given the alternatives to AT&T's network, we conclude that

---

318 See Letter from Chief, Common Carrier Bureau, to D.J. Culkin, Corporate Vice President, AT&T, June 7, 1984. We have since terminated these reports, after finding that AT&T's provisioning problems were resolved. We therefore do not believe that any special monitoring of AT&T's private line services is required.

319 See, e.g., ATT Tariff F.C.C. No. 9, Section 8.2.1.D (establishing parameters for voice grade private line, including: loss variation, attenuation distortion, C-message noise limit, C-notched noise limit; signal to C-Notched Noise Ratio, Intermodulation, Distortion, Envelope Delay Distortion, Impulse Noise, Frequency Shift, Phase Jitter).

320 Further Notice, 3 FCC Rcd at 3269-70 (para. 146).

competitive forces are more than likely to provide the impetus for AT&T to maintain its existing service quality levels, at least along those routes where facilities-based competition exists.

157. There are, however, areas where AT&T is not subject to facilities-based competition, or where facilities-based competition is hampered by the unavailability of equal access. Neglect of service quality is somewhat more likely in such areas than elsewhere, because the short term impact of such neglect on AT&T's revenues would not be as great as in areas of greater competition. We will therefore require AT&T to disaggregate its existing service quality reports so that the quality of service to non-equal access exchanges is separately reported. We delegate to the Bureau the task of devising specifications for these reports.

158. Our determination on this issue is further buttressed by our view of the importance of network quality in the public statements and marketing campaigns of AT&T and several of its leading interexchange competitors. While we agree with the Colorado OCC that an emphasis on quality in advertisements is not necessarily indicative of actual service quality, the prominence that service quality receives in carrier efforts to sign new customers will lead consumers and users to expect high quality service, and to seek out an alternative service provider if quality is not provided. Furthermore, we agree that for competition to operate effectively to deter service quality deterioration, customers must be able to change to a different facilities-based carrier. We do not agree, however, that the costs of accomplishing connection to a different interexchange carrier should necessarily be borne by someone other than the customer causing the change. Under rate of return regulation, the charges associated with terminating service by one interexchange carrier and instituting service with another have apparently not impeded the vigorous growth of competition for AT&T's services on the whole, and we have no reason to believe they will in the future under price caps. Nevertheless, our comprehensive review of price cap performance during its fourth year will evaluate a full range of service quality issues, and will permit us to investigate if AT&T is degrading its service quality, while at the same time preventing migration to other carriers through the use of unlawfully high charges for terminating service. In the interim, changes in AT&T's tariff terms and conditions affecting service termination policies shall be treated as any other nonstreamlined tariff filing. Moreover, if through our ongoing monitoring or our complaint process, we determine that deterioration is occurring, we stand ready to take whatever corrective action is necessary.

159. While a number of commenters argue that we should become more active in the service quality area with the advent of price cap regulation, we are not convinced that additional federal requirements are necessary at this time. Facilities-based competition for AT&T's services will force AT&T to maintain the quality of its network. For those areas not subject to facilities-based competition, we believe that our existing monitoring program, as well as our complaint process, provide us with enough information to detect

a drop-off in service quality. In making this decision, however, we are mindful that we possess an array of regulatory options that could be brought to bear should AT&T service quality degrade. The adoption of our own performance standards, increased monitoring, or even the adoption of contractual liability for installation and service failures are examples of the types of relief we would consider in the future should AT&T's service quality decline.[321] Furthermore, we intend to make service quality one of the criteria by which we evaluate the success of the price cap regime beginning at the end of its first three years. Our continued vigiliance during the initial period, together with the opportunity for more extensive exploration of this subject as part of the performance review, should also deter AT&T from inviting regulatory intervention into its own network performance objectives.

160. We do not find persuasive the views of those who argue that the experience of British Telecom under price cap regulation in Great Britain is dispositive of the issue. Regardless of the opinions of parties to this proceeding, Oftel's recent review of quality of service makes clear that the British experience is a reflection of events outside the control of British Telecom, e.g., a strike by British Telecom engineers, an unprecedented rise in demand for telecommunications services as the British economy privatized, and a storm that caused widespread damage to the network. Oftel reported that in 1986, prior to the strike, British Telecom had made considerable improvements in its ability to conduct repairs and in decreasing the number of problems with its system.[322] Furthermore, we note that service quality issues were to some degree inherited by the British price cap system from the prior government monopoly. AT&T is therefore in a far different position than British Telecom.

161. We have also carefully examined concerns that our proposals for the treatment of new and restructured services would contribute to service quality degradation under a price cap system. Some commenters believe that AT&T might force customers of its rate-capped services to migrate to new services outside the cap by degrading the quality of the capped service.[323] We do not believe that such a strategy is likely for several reasons. First,

---

321 We therefore disagree with arguments that network quality would be impossible to recreate if allowed to deteriorate. Indeed, as evidenced by Oftel's treatment of British Telecom, it is possible to assert regulatory controls that improve service quality. See B. Carsberg, "The Control of British Telecom's Prices," Oftel Statement, released July 7, 1988, at 32.

322 "Quality of Telecommunications Services Report," Oftel, November 1986.

323 We discuss our treatment of new and restructured services in Section III.C.4.d, infra.

as AT&T suggests, an unsatisfied customer is just as likely to move to another carrier instead of another AT&T service. Second, the new services that are initially offered outside the price cap are brought within price cap limitations after a relatively short period of time.[324] For a migration strategy to work over such a short period, it appears to us that the new service would not only have to be of decidedly superior quality, it would have to be less expensive. An offering of a superior service at a lower price is a benefit to users, so long as the carrier is foreclosed from unimpeded price increases once customer migration is accomplished. By moving a new service into price cap limits relatively quickly, we prevent the carrier from benefitting from such a strategy. Furthermore, our price cap system does not contemplate streamlining new services. As we discuss in Section III.C.4.d, infra, new service tariffs must be filed on 45 days' notice, and must be accompanied by a net revenue test showing. This Commission, as well as interested parties, will therefore have an opportunity to examine and challenge new service rates.

3. Impact on State Regulation

a. Summary of Further Notice

162. In the Further Notice, we stated that while our price cap proposal would not change jurisdictional allocation rules in any respect, a dominant carrier might attempt to circumvent jurisdictional allocation rules by inaccurately assigning costs to the state or interstate jurisdiction, in an attempt to increase total company profits.[325] We noted that the incentive to circumvent proper jurisdictional cost allocations exists under current regulation whenever a carrier operates pursuant to different state and interstate regulatory regimes. We stated that our ability to detect such activity had improved recently as a result of implementing ARMIS, a computerized system of collecting carriers' financial and operating data.[326] We tentatively concluded that price cap regulation should not adversely affect intrastate rates, services, or jurisdictional allocations. We sought comment on any unique incentives to allocate costs improperly between jurisdictions that might result from price cap regulation, and any

---

324 Id.

325 3 FCC Rcd at 3263-64 (para. 130).

326 Id. at 3264 (para. 131) (citing Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the Commission's Rules), Report and Order, 2 FCC Rcd 5770 (1987) (hereinafter ARMIS Order), recon., CC Docket No. 86-182, Order on Reconsideration, FCC 88-311 (released Oct. 14, 1988) (hereinafter ARMIS Reconsideration Order)).

specific changes in existing monitoring procedures that might be required to offset such incentives.[327]

b. Pleadings

163. States, consumer groups, and AT&T's competitors argue that price cap regulation provides carriers with an incentive to shift costs to the state jurisdiction so long as their intrastate activities remain regulated under rate of return. By shifting interstate costs to state rates, these parties argue, AT&T will be able to increase state rates, thereby earning higher profits on interstate services and generating additional revenue in the intrastate jurisdiction.[328] are subject to rate of return regulation, interjurisdictional cost shifting creates the risk of recapture in the next rate case, and that price cap regulation eliminates the risk of recapture and thus creates an additional incentive to shift costs.[329] Ohio PUC contends that telephone companies will invest in facilities with higher relative allocations to the state jurisdiction.[330] Comptel argues that price cap regulation will encourage AT&T to shift costs to the state jurisdiction so that it can justify lower charges for interstate services, for which it faces greater competition.[331]

164. Parties argue that the current separations rules will not prevent carriers from acting on the incentive to shift costs between jurisdictions. Maryland PC argues that the mere existence of the Separations Manual is not a basis for concluding that cost shifting does not occur.[332] Texas PUC argues that the current separations process leaves room for carrier abuse.[333] Florida's Citizens contend that the recent simplification of the Separations Manual gives carriers latitude to shift costs.[334] More specifically,

---

327 3 FCC Rcd at 3264-65 (para. 132).

328 Arkansas PSC Comments at 3-4; Ohio PUC Comments at 7; ALC Comments at 20; Wisconsin PSC Comments at 3; Michigan PSC Comments at 9; DC PSC Comments at 2; Alabama PSC Reply at 3; Texas PUC Reply at 5; Virginia Reply at 2; Comptel Comments at 38; Colorado OCC Comments at 10-11.

329 Colorado OCC Comments at 10-11.

330 Ohio PUC Reply at 4-5.

331 Comptel Comments at 38.

332 Maryland PC Reply at 13.

333 Texas PUC Reply at 5.

334 Florida's Citizens Reply at 2-3.

Colorado OCC contends that the separations rules rely on direct assignment of costs, and that these assignments are generally subject to the discretion of the carrier.[335] Nevada PSC states that the recent changes should prevent material shifts to the state jurisdiction, but is concerned about the cumulative effect of small shifts, for example, those that could result from rounding.[336]

165. States and AT&T's competitors conclude that safeguards are necessary in order to prevent cost shifting.[337] New Hampshire PUC states that this Commission should evaluate possible negative impacts on states and be prepared to work with state commissions.[338] New York DPS, Nevada PSC, and Wisconsin PSC request that this Commission continue monitoring at present or increased levels.[339] Nevada PSC contends, however, that monitoring cannot prevent cost shifting, but can only identify it.[340] Ohio PUC suggests that ARMIS can be used to monitor for cost shifting, while the Colorado OCC argues that ARMIS is untested.[341] ALC contends that this Commission cannot adequately monitor possible jurisdictional cost shifting, and Comptel seeks additional explanation of the way in which monitoring will detect cost shifting.[342]

166. States offer additional and alternative proposals to eliminate the potential for cost shifting. The Michigan PSC proposes that this Commission either require that any percentage change in jurisdictional cost allocations have prior state and Commission approval, or that we make the separations rules more specific and detailed in order to prevent abuse.[343] Colorado OCC

---

335 Colorado OCC Comments at 17.

336 Nevada PSC Comments at 1-2.

337 See, e.g., Michigan PSC Comments at 9.

338 New Hampshire PUC Comments at 8.

339 New York DPS Comments at 22; Nevada PSC Comments at 2; Wisconsin PSC Comments at 3.

340 Nevada PSC Comments at 2.

341 Ohio PUC Comments at 7-8; Ohio PUC Reply at 5; Colorado OCC Comments at 17-18.

342 ALC Comments at 20; Comptel Comments at 39.

343 Michigan PSC Comments at 10.

argues that this Commission should either require all separations cost changes to be flowed through as exogenous cost changes, or revise Part 36 to limit discretionary direct assignment.[344] New York DPS suggests that we prohibit carriers from increasing the proportion of costs allocated to the intrastate jurisdiction. New York DPS argues that this prohibition is reasonable because price cap regulation will increase usage, and therefore the proportional interstate assignment.[345] Finally, Ohio PUC recommends that in future modifications of the separations rules, we consider the potential for manipulation.[346]

167. Carriers respond that price cap regulation does not result in unique incentives to misallocate costs between jurisdictions, and that existing safeguards are adequate to forestall any cost shifting. Bell Atlantic and GTOC contend that price caps will not adversely affect state rates by encouraging misallocation of costs.[347] Exchange carriers argue that there have been differences in federal and state regulation for decades, and that incentives to shift costs are not unique to price caps.[348] Pactel argues that because many states have adopted forms of regulation other than rate of return, price cap regulation may actually eliminate incentives to misallocate costs.[349] AT&T states that 17 states have moved away from rate of return regulation for AT&T.[350] AT&T also states that less than 25 percent of its revenues are intrastate, and that since it faces competition for both interstate and intrastate services, it has no incentive to charge prices that are higher than competitive costs.[351]

168. Bell Atlantic, Pactel, and AT&T state that the Separations Manual prescribes the way in which costs are to be allocated between the state and interstate jurisdictions.[352] AT&T contends that unlike the LECs, it offers

---

344 Colorado OCC Comments at 30.

345 New York DPS Comments at 22.

346 Ohio PUC Reply at 5.

347 Bell Atlantic Comments at 6; GTOC Comments at 11.

348 Bell Atlantic Comments at 6-7; Pactel Comments at 13; BellSouth Reply at 17.

349 Pactel Comments at 13.

350 AT&T Reply at 7 n.**.

351 Id.

352 Bell Atlantic Comments at 7; Pactel Comments at 13; AT&T Reply at 7

the same mix of services in both jurisdictions, so that its allocation of costs is relatively insusceptible to manipulation.[353] Carriers argue that existing safeguards, including ARMIS, and state scrutiny, will preclude jurisdictional cost shifting.[354] United asserts that ARMIS requires carriers to report various data by state and interstate jurisdiction, and will permit states and this Commission to compare data over time, and detect changes. BellSouth suggests that, if necessary, this Commission could expand the ARMIS reports.[355] Finally, NYNEX states that the Federal-State Joint Board is developing further procedures to monitor cost shifting.[356]

c. Discussion

169. The possibility of cost-shifting is inherent in a bifurcated regulatory system. Federal and state regulation of AT&T has never been identical; the incentive to circumvent jurisdictional cost allocations exists whenever a carrier operates pursuant to different state and federal regulatory regimes. Indeed, cost shifting incentives exist even if both the intrastate and interstate jurisdiction employ rate of return, so long as the earnings targets are different. Therefore, this Commission, along with the state commissions, has developed rules and monitoring programs to identify and prevent cost shifting. We conclude that the combination of the separations rules, Commission monitoring associated with ARMIS, and state monitoring will be effective in identifying and correcting the misallocation of costs to either the state or interstate jurisdiction.

170. Two facts suggest that AT&T has neither the incentive, nor the ability, to hide cost shifts: the bulk of AT&T's costs are interstate costs, and an increasing number of states are reducing regulation for AT&T in response to growing competition. Access costs, which cannot be shifted, represent approximately half of AT&T's total costs. Approximately 84.6 percent of AT&T's total non-access costs are interstate costs.[357] In

---

n.**.

353 AT&T Reply at 7 n.**.

354 GTOC Comments at 12; NYNEX Comments at 38 n.44; Pactel Comments at 13; United Comments at 24 n.30.

355 BellSouth Reply at 17.

356 NYNEX Reply at 60.

357 See AT&T Communications, CC Docket No. 87-611, Direct Case of AT&T (filed Jan. 28, 1988), Attachment 3. If access costs are included, 75.7 percent of AT&T's total costs are interstate. See AT&T FDC Report for the 12 Month Period ended 12/31/87 (filed June 30, 1988), Schedule 1; Preliminary

addition, as more states embark upon incentive-based modes of regulation, the likelihood of cost shifting decreases. As we noted in Section II.B, approximately 20 states have moved away from rate of return regulation of AT&T's interexchange services in the past few years. We therefore conclude that to the extent adoption of a price cap system for AT&T at the federal level presents jurisdictional cost shifting incentives, regulatory reform at the state level is rapidly decreasing AT&T's incentives to shift costs.

171. In addition, there are two regulatory activities we undertake that have a bearing on opportunities for cost shifting. First, AT&T will continue to file quarterly ARMIS reports,[358] which will be available to all interested parties, subject to our rules on request for confidential treatment of proprietary filings, that permit this Commission to monitor AT&T's allocations of costs and revenues between the interstate and intrastate jurisdiction.[359] We also expect that, in those states that continue to employ rate of return, state commissions will continue to scrutinize AT&T's state costs, and disallow those they regard as unjustified.

172. Second, this Commission, together with various Federal-State Joint Boards, has repeatedly modified and updated the separations rules in an effort to ensure that a rational cost allocation system exists that reflects current technology. None of these rules will change as a result of any action we take in this proceeding.[360] Since both the federal and state commissions review separations results, shifting costs in a manner that runs counter to our requirements invites regulatory intervention. While there may be disputes

---

Domestic Statistics Year Ended Dec. 31, 1987, FCC (Aug. 17, 1988).

358 Elimination of FCC Form 901, Monthly Form Required From Telephone Companies, CC Docket No. 87-503, Report and Order, 3 FCC Rcd 6261 (1988) (hereinafter Form 901 Order).

359 See Form 901 Order, 3 FCC Rcd at 6262-63.

360 In fact, we only recently completed a proceeding updating and simplifying our separations procedures with the assistance of state commissioners serving on the Joint Board. See Amendment of Part 67 (New Part 36) of the Commission's Rules and Establishment of a Federal-State Joint Board, CC Docket No. 86-297, Recommended Decision and Order, 2 FCC Rcd 2582; Report and Order, 2 FCC Rcd 2639 (1987). This Commission also adopted the Joint Board's recommendation that review of jurisdictional revenue shifts resulting from these separations changes be included in the monitoring program established in Docket 80-286 to examine the effects of the nontraffic sensitive recovery changes adopted by the Joint Board in May 1987. See Monitoring Report, CC Docket No. 87-339 (September 1988) at 157. Monitoring for jurisdictional shifts currently applies only to the LECs.

concerning interpretations of the separations rules, the existence of rules themselves operates as a constraint on carrier practices. Given the current trend toward incentive-based regulation at the state level, we do not believe that an attempt to narrow the range of disagreement about the application of separations rules is a necessary or useful precursor to the implementation of price cap regulation for AT&T.[361]

4. Administrative Savings

a. Summary of Further Notice

173. In the previous section discussing the benefits of incentive regulation, we found that significant administrative savings would accrue in the long run if we implemented incentive regulation for dominant carriers.[362] We stated that incentive regulation, by eliminating the need to target individual rates to a specified rate of return using forecasted data, would substantially lessen the burdens of filing and reviewing proposed tariffs.

b. Pleadings

174. Several parties have submitted comments concerning the possible administrative savings we can expect to see if we adopt incentive regulation for AT&T. API argues that the administrative savings associated with a price cap system are not likely to be apparent since substantial cost accounting and reporting requirements remain in place for AT&T.[363] API also argues that the price cap regulations we proposed in the Further Notice themselves pose an onerous burden for AT&T.[364] Comptel argues that our proposed rules are onerous and will not produce administrative savings, particularly since they require information to be filed by rate element.[365] USTA argues that savings from a price cap system will accrue, but only if the same plan is simultaneously adopted for the LECs.[366]

---

361 For a discussion of exogenous treatment of separations changes, see Section III.C.1.d, infra.

362 See Section II.B, supra.

363 API Comments at 11.

364 Id. at 12-13.

365 Comptel Comments at 37.

366 USTA Reply at 15-16.

c. Discussion

175. We find no reason, in considering implementation of incentive regulation for AT&T, to depart from our earlier observations that, in the long run, incentive regulation produces administrative savings in comparison to rate of return. In the following few sections of this Order, we describe the price cap mechanism that we will apply to AT&T. Due to the way we have structured the AT&T plan, the amount of information AT&T must collect and file under a price cap system is substantially less than under rate of return. We summarize some of the most important changes here. First, the reductions in AT&T's tariff filing burden will be substantial, provided its rates remain within the no-suspension zone we identify in this Order. Under the plan we adopt in this Order, the tariff support materials accompanying a streamlined rate level change must include a mathematical demonstration that actual prices are less than the price cap we establish. Only if AT&T files rates outside the no-suspension zone do the tariff support materials routinely required to justify a proposed rate become more burdensome.[367] In addition, the information AT&T must collect to satisfy our cap and band requirements is historical information; no longer will we need to review projections of network usage. As a result, the salient part of the tariff review process is generally reduced to an evaluation that the calculations (and allocations of exogenous costs) we have required have been performed correctly.[368] Furthermore, because our final rules for AT&T adopt service category banding, the number of filings that qualify for streamlined treatment is likely to be larger than if we had elected to employ rate element banding.[369] Finally, implementation of incentive regulation for AT&T permits us to discontinue use of the Interim Cost Allocation Manual (ICAM), that in its current form compels the separation of AT&T's costs into two broad service categories.[370] Elimination of the ICAM, and our administration of it, will have the effect of producing administrative savings.

---

367 Of course, additional support materials would also be required were this Commission to authorize an investigation of a below-cap, streamlined rate proposal.

368 Some estimation techniques will be required in the case of restructuring or abandoning a service. See Section III.C.3.b, infra.

369 A 5 percent upward band on changes in rate element prices, as proposed in the Further Notice, may have created pricing inefficiencies for a carrier seeking streamlined treatment of tariffs. See AT&T Comments at 20-22. As a result, AT&T might have filed fewer within-band, below-cap rate proposals.

370 See Section III.D, infra.

176. We recognize that the process of implementing incentive regulation, because it is different from rate of return regulation, will probably require AT&T to deploy a higher level of resources initially to implement new data collection and tariff preparation mechanisms. Nevertheless, we believe that the incentive regulation plan we adopt herein for AT&T will be less burdensome for it to comply with over the long term.[371] We also believe that incentive regulation will reduce the administrative burdens on this Commission, since a number of AT&T tariff filings will be susceptible to relatively straightforward and simple review.[372]

B. Initiation of Price Cap Regulation

1. Selection of a Regulatory System

a. Summary of Further Notice

177. In the Further Notice, we proposed that price cap regulation be elective for AT&T and the LECs in order to alleviate the concern that application of our formula would unintentionally force a hardship on any particular LEC or the customers served by that LEC.[373] We tentatively concluded that allowing carriers to elect price cap regulation initially would be in the public interest, and we sought comments on this tentative conclusion.[374] We also sought comment on an alternative proposal, mandatory price cap regulation for AT&T and all Tier 1 LECs, with an election for the remaining eligible LECs.[375]

b. Pleadings

---

371 Arguments that we are not eliminating our accounting or other regulatory requirements and therefore will not realize substantial savings miss the point. Incentive regulation, as we apply it to AT&T, is focused on the tariff process, and is not intended to render obsolete useful regulatory apparatus, such as the USOA, Joint Cost rules, or the Separations rules. See Section V, infra.

372 See Section III.C.4, infra, for a discussion of the tariff requirements that we mandate for AT&T.

373 3 FCC Rcd at 3283 (para. 170).

374 Id. at 3286 (para. 176).

375 Id. at 3286-87 (para. 177).

178. Exchange carriers and CCIA favor permitting carriers to elect either price cap or rate of return regulation.[376] BellSouth argues that elections ensure that both carriers and customers (through the regulator) believe they will benefit from price cap regulation.[377] US West contends that election allows carriers to determine whether they can be more productive under price cap regulation.[378] Illinois states, on the other hand, that while it is not opposed to voluntary participation as a transitional measure for a trial period, use of voluntary participation beyond that period will not allow the full benefits of price cap regulation to be realized.[379]

179. NTIA, state commissions, and customers oppose elective price cap regulation. These parties argue that if price cap regulation is indeed in the public interest, carriers should be required to comply.[380] State commissions and customers argue that if price cap regulation is not mandatory, carriers will select the method of regulation that maximizes their profits, and ratepayers will not benefit from price caps and may be harmed.[381] NARUC and DC PSC contend that because carriers have access to better financial and business planning information than do regulatory agencies, this Commission will be unable to fully scrutinize the basis of their decision.[382] NTIA argues that caution can be exercised and ratepayers benefited without allowing all firms the option to remain under rate of return regulation.[383] Finally, Michigan PSC supports our tentative conclusion that carriers opting for price

---

376 CBT Comments at 7; BellSouth Comments at 10; US West Comments at 53; CCIA Comments at 7.

377 BellSouth Comments at 10.

378 US West Comments at 53.

379 Illinois Comments at 15-16.

380 IDCMA Comments at 53; NTIA Comments at 5; ICA Comments at 23; Michigan PSC Comments at 19; New York DPS Comments at 5; Wisconsin PSC Comments at 7; Florida's Citizens Reply at 4; Oregon PUC Reply at 2.

381 Arkansas PSC Comments at 3; DC PSC Comments at 19; Missouri PSC Comments at 6-7; New York DPS Comments at 6; Wisconsin PSC Comments at 7; Ad Hoc Comments at 12; Executive Agencies Comments at 12-13; ICA Comments, BRI Report at B69-72; Comptel Comments at 7; Florida's Citizens Reply at 3; NARUC Reply at 7, Appendix D; Texas PUC Reply at 7.

382 NARUC Reply at 7; DC PSC Comments at 19-20.

383 NTIA Comments at 6.

cap regulation cannot revert to rate of return regulation during the initial price cap review period.[384]

c. Discussion

180. The concerns that motivated this Commission to propose introduction of price cap regulation on a voluntary basis were LEC-oriented. We perceive no impediment in the design of our price cap system that would make a mandatory approach for AT&T undesirable. To the contrary, for the reasons discussed above, we believe such a system will be in the public interest, and consequently should be mandatory. We therefore require AT&T to file price cap tariffs (i.e., tariffs following the price cap format regarding the information provided)[385] on an annual basis, in the manner, and on the dates, specified below.

2. Initial Price Cap Filing

a. Summary of Further Notice

181. In the Further Notice, we tentatively decided that AT&T would file its first price cap tariffs on February 16, 1989, with an effective date of April 1, 1989.[386] We proposed to require that, after the initial filing, AT&T update its filings each year, and that after the first year, annual price cap tariffs take effect on July 1 of each year, after a 45-day notice period.[387]

b. Pleadings

182. Arkansas PSC and NTN contend that price cap regulation raises so many difficult issues that the proposed April 1, 1989, implementation date is unrealistic.[388] Michigan PSC argues that the industry needs at least six months to prepare the proper information, and that the states need one year to implement plans consonant with the regulation adopted by this

---

384 Michigan PSC Comments at 19. But see Missouri PSC Comments at 7 (although Commission has said there will be no reversion to rate of return, in practice, the ability to file above-band and above-cap rates permits carriers to return to traditional regulation).

385 AT&T may, of course, as discussed in Section III.C.4, infra, file price cap tariffs that do not qualify for streamlined treatment, but even these tariffs must follow the price cap format.

386 3 FCC Rcd at 3368 (para. 304).

387 Id. at 3368-69 (para. 306).

388 Arkansas PSC Comments at 3; NTN Comments at 2-3.

Commission.[389] AT&T, however, states that price cap regulation can readily be implemented as scheduled on April 1, 1989.[390]

c. Discussion

183. We now decide that AT&T's initial price cap filing will be effective on July 1, 1989, on not less than 45 days' notice, and that annual price cap tariffs thereafter will take effect on July 1 of each year, after a 45-day notice period. Price cap regulation presents the potential for substantial consumer benefits that we believe ought not to be delayed. Since the release of our original Notice in August, 1987, we have been grappling with the issues surrounding application of price caps to AT&T. With the release of this Order, we resolve each of these issues, enabling us to implement price cap regulation at the earliest practicable date. Furthermore, AT&T states that it will be able to prepare and file its first price cap tariffs with us promptly. AT&T's stated willingness to file tariffs promptly is an adequate response to Michigan PSC's argument that the industry needs six months to prepare. Should AT&T's initial filing prove inadequate, we would, of course, suspend it. In addition, as 20 states have already moved away from rate of return regulation for AT&T, we do not consider it necessary to delay the consumer benefits promised by price cap regulation to permit states to decide whether they want to enact similar plans on the state level. The movement from rate of return regulation to incentive regulation is an on-going process, and this Commission is behind many state Commissions in accomplishing that transition.

184. We therefore conclude that AT&T's initial price cap filing will be filed on not less than 45 days' notice, with an effective date of July 1, 1989. After the initial filing, AT&T will be required to update its price cap indexes each year; annual price cap tariffs will take effect on July 1 of each year, after a 45-day notice period. As access charges are exogenous cost factors in AT&T's price cap indexes, and we wish to continue our access flow-through policies, it is desirable to continue the practice of coordinating AT&T's annual filings with those of the LECs. The schedule established here for AT&T reflects our recent revisions to the annual filing schedule for the LECs.[391] As we explain in Section III.C.4, AT&T is free to file rate changes for any service at any time subsequent to the effective date of its annual tariff filing, subject to the price cap tariff rules set out in this Order.

---

389 Michigan PSC Comments at 25.

390 AT&T Reply at 6.

391 See Access Tariff Filing Schedules, CC Docket No. 88-326, Report and Order, 3 FCC Rcd 5495 (1988).

C. Mechanics of Incentive Regulation

1. The Price Cap Index

185. The "price cap" we tentatively selected in the Further Notice consisted of a formula that would track inflation, carrier productivity, access costs, and other costs beyond a carrier's control. The formula we proposed essentially would permit carrier rates to fluctuate by a measure of inflation less a productivity offset, representing the amount by which carrier productivity has historically exceeded productivity gains in the economy generally. The value attached to the inflation less productivity factor would also be permitted to move up or down in response to specific exogenous cost changes, including access costs for AT&T, that we identified in the Further Notice. Our intent in fashioning such a formula was to ensure that aggregate rates under a price cap regime could move in response to changes in carrier costs, thereby keeping rates in the zone of reasonableness.[392] The various components of our price cap index (PCI) have drawn substantial comment by the parties. In addition, we have also received comments on the operation of the formula itself. The following section discusses these issues.

a. GNP-PI

i. Summary of Further Notice

186. In the Further Notice, we proposed to use the Gross National Product Price Index (GNP-PI) as the measure of inflation that most closely mirrors changes in the cost of factors of production faced by dominant carriers.[393] We tentatively chose this index over other alternatives, such as the Consumer Price Index (CPI) and the Producer Price Index (PPI), for several reasons. The CPI measures changes only in the cost of final goods purchased by consumers, whereas the GNP-PI is a more broadly-based index that also includes investment goods. As a result, the GNP-PI is less volatile than the CPI, and is less subject to atypical price increases in one or two sectors of the economy, such as energy or medical care. The PPI represents changes

---

392 This is essentially what carriers do under rate of return regulation, requesting changes in rates to reflect changes in access costs and other input costs.

393 Further Notice, 3 FCC Rcd at 3389-92 (paras. 346-54). The index we proposed is published in the following two sources: Bureau of Economic Analysis, U.S. Dept. of Commerce, Surv. of Current Bus., Vol. 67, No. 12 (Dec. 1987) at 11 and Table 7.1 and Economic Report of the President (1988) at 254 and Table B-4.

in the prices charged by the producers of manufactured goods. As such, the PPI ignores price changes in the retail trade, service, and construction sectors of the economy. We also tentatively found that sub-indexes of the PPI, which we also considered as a possible measure of carrier cost inflation, have the same deficiencies as the PPI.

187. In addition, we tentatively concluded that substantial difficulties exist in selecting which PPI sub-indexes to employ.[394] We also tentatively rejected use of the "implicit" GNP deflator because it is a Paasche index, which can fluctuate due to factors unrelated to inflation.[395] We also tentatively rejected as unneccessary and procedurally cumbersome, the development of a new index to reflect changes in prices and productivity specific to the telecommunications sector.

188. We proposed to measure changes in the GNP-PI by comparing the GNP-PI for the quarter ending six months before the effective date of the tariff to the GNP-PI for the same quarter ending the previous year. Thus, for tariffs effective April 1, 1989, the relevant growth rate in GNP-PI would be the growth from the third quarter of 1987 to the third quarter of 1988. We also proposed to use the estimate of GNP-PI that is available 75 days after the close of the quarter.

ii. Pleadings

189. Those discussing our proposed measure of inflation are divided on which index best mirrors changes in the cost of factors of production faced by carriers. Most carriers that commented, including AT&T, favor the use of the GNP-PI to adjust the price cap for inflationary changes.[396] The GNP-PI also received the support of a several user groups and other parties.[397] Several parties oppose the GNP-PI, however, arguing that as a

---

394 Further Notice, 3 FCC Rcd at 3392 (para. 353).

395 Id. at 3392 n.774. As we explained in the Further Notice, a Paasche index may fluctuate due to changes in the relative composition of the GNP, even when no prices change.

396 AT&T Comments at 43 n.*; GTOC Comments at 37-38; see also Centel Comments at 9; NYNEX Comments at 34; Pactel Comments at 18-20, App. 1; SNET Comments at 8-9; US West Comments at 39; Pactel Reply at 70; USTA Reply at 30. Bell Atlantic computes an industry cost index from a Bell System capital price index, an industry labor price index, and an economy-wide index (the "implicit" GNP deflator) for materials, rent, and supplies, and compares this index to the GNP-PI. Bell Atlantic Reply at 7 n.15 & App. III.

397 CCIA Comments at 11; EDS Comments at 12; Ohio PUC Comments at 14-15; TCA Reply at 19 n.39. See also Ad Hoc Comments at 23 n.19 (agreeing that

broad-based index, the GNP-PI reflects costs unrelated to telecommunications.[398]

190. Others argue for the use of one of the other indexes discussed in the Further Notice. BellSouth, alone among the carriers, favors the use of the CPI, arguing that, as an inflation measure[399] the CPI is generally accepted and understood, and many carriers' wage contracts and leases use it for inflation adjustments.[400] The GNP-PI, it argues, may under-represent cost changes, since the GNP-PI growth rate is lower than that of the CPI. BellSouth states that this may result in non-recovery of legitimate cost increases, especially in times of rapid inflation. Illinois argues that in choosing an inflation index this Commission should consider four factors: (1) low implementation costs; (2) the ability of a regulated firm to affect the index; (3) absence of volatility; and (4) relevancy to input costs.[401] Following these criteria, Illinois recommends we employ sub-indexes of the PPI, arguing that the difficulties we perceived in selecting relevant sub-indexes are illusory.

191. NTIA compares the performance of the GNP-PI with the performance of the CPI, PPI, the "implicit" GNP-PI deflator, and an index developed for AT&T as part of its pre-divestiture studies of Bell System total factor productivity.[402] NTIA argues that AT&T's pre-divestiture index is likely to best reflect actual inflation experience over time, and that the "implicit" GNP deflator statistic best matches this index. According to NTIA, we should not be troubled that the "implicit" GNP deflator is a Paasche index because "theoretical considerations should . . . take a back seat to empirical considerations."[403] Both USTA and Pactel contest NTIA's evaluation of the

---

the GNP-PI is better than the CPI); ICA Reply, Exh. A at 8-10 (supporting the selection of the GNP-PI.)

398 Connecticut OCC Comments at 11-12; Florida PSC Comments at 4. See also New York DPS Comments at 10 (finding that the analysis supporting use of the GNP-PI is insufficient); ICA Comments, App. B (BRI Report) at 51 (arguing that any general index includes costs unrelated to telecommunications); Oregon PUC Reply Comments at 10; Maryland PC Reply at 11.

399 BellSouth Comments at 23-24, 34-37.

400 See SNET Comments at 8 n.21.

401 Illinois Comments at 20-23.

402 NTIA Comments at 9-10 & App. A.

403 Id. at App. A at 5.

GNP deflator.[404] These parties argue that the correlation discovered by NTIA between the GNP deflator and the AT&T index is a function of studying the 1959-1979 performance of two indexes, from the point of view of a 1982 base period. USTA argues that the 1982 versions of the two indexes would not have been available from 1959-1979, and that use of the actual index values in effect during that 20-year period would not have produced the correlations NTIA found in its 1982-based analysis.[405]

192. A third set of commenters prefers the use of an industry-specific cost index. Most states that commented on this issue advocate the development and use of a telephone industry-specific cost index. The DC PSC wants us to develop a telephone company based cost index, or at least raise the productivity offset to compensate for the use of the GNP-PI, which they claim is higher than an actual cost index would be.[406] The Maryland PC also proposes development of an industry-specific cost index, objecting to the use of GNP-PI because telephone company price increases have lagged behind overall inflation.[407] The Ohio PUC suggests we use GNP-PI for the initial four-year period of price caps, but solicit comments on the development of an industry specific cost index, developing the index during that initial four years.[408] Ad Hoc also is willing to accept use of the GNP-PI, but prefers the use of an industry-specific index.[409]

iii. Discussion

193. None of the commenters in this proceeding have persuaded us to discard the GNP-PI as the measure of inflationary changes faced by dominant carriers. In proposing the GNP-PI, we sought an index that would reflect changes in the costs that carriers face and that would not exhibit volatility attributed to inflationary pressures in one or two sectors of the economy. We also sought an index that could not be influenced by individual carriers or groups of carriers. While we recognized that no existing index perfectly reflects the cost changes faced by the industry, we found that a broad-based

---

404 USTA Reply at 31 n.79; Pactel Reply at 71-72.

405 USTA Reply at 31 n.79.

406 DC PSC Comments at 10. See Wisconsin PSC Comments at 6-7.

407 Maryland PC Comments at 16-17. Contra USTA Reply at 30-31; Pactel Reply at 69-70.

408 Ohio PUC Comments at 14-15.

409 Ad Hoc Comments at 23.

index would best match the criteria we sought in a carrier inflation indicator. Based on a review of these factors and the arguments presented by parties, we continue to believe the GNP-PI is the best option among existing indexes for measuring the cost of inflation for the purposes of our price cap formula.

194. As we stated in the Further Notice, the GNP-PI summarizes price changes in all sectors of the economy.[410] This characteristic is important in several respects. First, the broad-based nature of the GNP-PI means that changes to the statistic cannot be substantially influenced by inflationary pressures experienced by only one or two economic sectors. Furthermore, the carriers themselves can do little to influence changes to the GNP-PI. Finally, the broad-based GNP-PI better reflects the inflationary pressures faced by carriers than does a narrower index focusing on prices faced by consumers or manufacturers.

195. In contrast to the GNP-PI, the CPI and PPI reflect fewer sectors of economic activity and thus, by their very nature, are more volatile and are less likely to reflect the costs faced by carriers.[411] Arguments that contracts for certain goods and services are tied to CPI increases, or that PPI sub-indexes should be employed, are beside the point. Not all contracts are tied to the CPI, nor does the PPI or its sub-indexes measure exactly the cost change of every input a carrier uses. In searching for an index that reflects the totality of the inflationary pressures faced by carriers, the broad-based GNP-PI is superior to indexes that reflect only consumer prices or the prices faced by manufacturers.

196. We have also carefully scrutinized NTIA's suggestion to adopt the GNP deflator in place of the GNP-PI. We are not convinced that the correlation between the GNP deflator and the AT&T pre-divestiture index overcomes the fundamental difficulties of adopting a Paasche mechanism for use as a price index.[412] Moreover, the AT&T factor cost index used as a benchmark is taken from a single study, and although we have cited other results of that study in determining AT&T's historical productivity, we have avoided reliance on single sources and do not necessarily endorse any

---

410 Further Notice, 3 FCC Rcd at 3390 (para. 348).

411 Id. at 3391 (para. 350) & n.773.

412 The Commerce Department itself cautions against using the GNP deflator as an index of cost changes, stating in a footnote to Table 8.1, page 15 of the Survey of Current Business, June 1988, Vol. 68, No. 6, that "the implicit price deflator reflects not only changes in prices but also changes in the composition of GNP, and its use as a measure of price change should be avoided."

particular cost measure from any one study. In addition, the criticisms raised by USTA and Pactel regarding NTIA's analysis using 1982 weights cast doubt on whether, on a going-forward basis, the "implicit" GNP deflator will mirror telecommunications cost changes in the way NTIA's study seems to suggest. We therefore find, on the basis of the record before us, that the GNP-PI is the best choice among available indexes for use in the PCI formula.

197. We also reject commenters' suggestions that we develop an industry-specific cost index. While we recognize that an index specific to the costs faced by dominant carriers could theoretically produce the most accurate measurement of changes in input costs, we believe the practical problems associated with such an index render the GNP-PI the superior alternative.[413] Unlike a broad-based index, a specific index of the type suggested by some commenters would be based on cost changes to economic inputs that carriers themselves could influence. Moreover, none of the parties advocating a telecommunications-specific index presents any workable methodology for developing such an index. By contrast, the GNP-PI is readily available, easily understood and immune to manipulation by the carriers. It also measures changes in the costs of inputs that carriers purchase. We therefore find that the GNP-PI is a superior alternative to the uncertainty of developing an industry-specific index.[414]

---

413 DC PSC and Maryland PC favor creation of an industry specific index because of the observed difference between telecommunications price trends and prices in the economy as a whole. In our formula we address that difference through the productivity offset.

414 No party suggests that our proposal to measure the annual change in the GNP-PI would be unworkable or undesirable. Accordingly, we adopt the proposal set forth in the Further Notice to measure changes to the GNP-PI by comparing the GNP-PI for the quarter ending six months before the effective date of the tariff to the corresponding quarter of the previous year. Further Notice, 3 FCC Rcd at 3393 (para. 355). In addition, while the LECs raise a concern that the 75-day estimate of the GNP-PI does not provide for sufficient time to prepare an annual price cap filing, no concern was voiced by or about AT&T's employing the 75-day estimate. We therefore adopt the 75-day estimate for use by AT&T in its PCI calculations. We renew our consideration of this issue as it applies to LECs in section IV.C.1.b, of this Order.

b. Productivity

i. Summary of Further Notice

198. In the Further Notice, we tentatively found that any form of regulation that is based on the costs of production must take productivity gains into account. Since our price cap plan explicitly permits aggregate prices to move in proportion to cost changes as measured by the price cap index, we tentatively proposed to include in our price cap formula a measure of carrier productivity gains. The Further Notice explains how productivity gains affect prices as follows:

> Productivity advances in a firm or industry are manifested in increased output from the same amount of factors of production, or equivalently, the same amount of output from decreased levels of factor utilization. In either case, the dollar cost of a unit of output declines due to the diminished factor requirement per unit of output. Of course, if some or all factor prices are rising at the same time, those price rises will at least partially offset the reductions that would flow from improved productivity by itself. Nonetheless, the net price effect of productivity and any such factor price increases would continue to be less than the factor cost changes in isolation.[415]

In the Further Notice, we tentatively found that the GNP-PI automatically reflects certain productivity gains in the economy, but does not necessarily reflect the entirety of productivity gains experienced by carriers.[416] We stated that the GNP-PI measures changes in the level of actual market prices, which nets out any productivity gains from price increases that would otherwise occur.[417] We also stated that to the extent the productivity of the

---

415 Further Notice, 3 FCC Rcd at 3399-3400 (para. 363).

416 See J. Kendrick, Understanding Productivity 76-77 (1977); E.F. Sudit, Automatic Rate Adjustments Based on Total Factor Productivity Performance in Public Utility Regulation, in Problems in Public Utility Economics and Regulation (M. Crew ed. 1979).

417 Further Notice, 3 FCC Rcd at 3400 (para. 364). As we stated in the Further Notice, if the cost of factors required to produce a unit of output rises by 5 percent, but productivity increases by 2 percent, then actual market prices need increase by only 3 percent to maintain the same level of

telecommunications industry differs from that of the economy as a whole, its productivity is not fully reflected in the GNP-PI.[418]

199. Productivity can be measured in several ways. Perhaps the simplest is a one factor productivity index, such as BLS's labor productivity index. This measures changes in output per employee or per employee hour. There are two factor indexes which measure output per some weighted aggregate of capital and labor. There are also three-, four- and total factor productivity measures, which add further inputs such as land and materials and supplies to capital and labor to measure output per unit of input.

200. We examined several studies of telecommunications industry productivity to determine if a productivity adjustment beyond that implicit in the GNP-PI was necessary. Each study indicated that the telecommunications industry is a most productive sector of the economy. A study of total factor productivity, performed for AT&T by an outside consultant and filed in United States v. AT&T,[419] found that Bell System productivity from 1947 to 1978 was 2.1 percent greater than the productivity of the economy as a whole.[420] Another total factor productivity study performed by AT&T itself[421] found a productivity differential of 1.9 percent for the years 1947 to 1978. AT&T's study also concluded that productivity rose in later years: from 1948 to 1965, the differential favoring the Bell System was 1.1 percent; from 1965 to 1972, it was 2.1 percent, and from 1972 to 1978, it was 3.9 percent.

201. We cited two other published studies.[422] One examined four-factor productivity within the Bell System, finding an average annual increase in productivity of 4.09 percent for the period 1947-1976.[423] The other study

---

producer profit. Id.

418 Id. at 3400 (para. 365).

419 Testimony of L. Christensen filed in United States v. AT&T, Civ. Action No. 74-1698 (D.D.C. filed Nov. 20, 1974) (hereinafter Christensen Testimony). The trial in that case terminated in the consent decree divesting the Bell Operating Companies from AT&T. See United States v. AT&T, 552 F.Supp. 131 (D.D.C. 1982), aff'd sub nom. Maryland v. United States, 460 U.S. 1001 (1983).

420 Further Notice, 3 FCC Rcd at 3401 (para 368). That study also concluded that for the period 1966-1978, the differential rose to 3 percent. Id.

421 AT&T, Bell System Productivity Study 1947-78 (Nov. 1979).

422 Further Notice, 3 FCC Rcd at 3402 (para. 371).

423 M.I. Nadiri & M. Schankerman, The Structure of Production, Technological Change, and the Rate of Growth of Total Factor Productivity in the U.S. Bell

measured total factor productivity of Bell of Canada,[424] which provided productivity measurements similar to those taken of the U.S. Bell System.

202. Three other pieces of evidence were cited in the Further Notice to corroborate the findings of the above studies. The American Productivity and Quality Center (APQC) calculates measures of productivity for the economy as a whole and for the communications industry.[425] The APQC measure shows a communications industry advantage in productivity of 2.2 percent from 1948-1985.[426] In addition, we found that comparison of the overall CPI with the CPI sub-index for telephone services (local and long distance) also shows a differential of 2.25 percent per year for the period 1935-1985.[427] Finally, we computed AT&T's productivity in the post-divestiture period by evaluating AT&T's price experience as if our plan had been in effect.[428] We found a productivity differential of 2.48 percent, similar to the long term studies of the Bell System.

203. We noted that, with the exception of our post-divestiture analysis of AT&T, none of these productivity studies distinguished interstate from intrastate services. Nevertheless, we tentatively found that the studies do indicate that the telecommunications industry is likely to have productivity gains above those of the economy as a whole. We therefore

---

System, in Productivity Measurement in Regulated Industries (T. Cowing & R. Stevenson eds. 1981). The authors of this study found that the productivity differential increased from 3.50 percent during 1947-1957 and 3.65 percent during 1953-1967, to 4.96 percent during 1968-1976.

424 M. Denny, M. Fuss & L. Waverman, The Measurement and Interpretation of Total Factor Productivity in Regulated Industries, with an Application to Canadian Telecommunication, in Productivity Measurement in Regulated Industries (T. Cowing & R. Stevenson eds. 1981). This study reported an average annual increase of 3.35 percent over the period 1952-1976, rising from 1.3 percent in the first five years to 4.5 percent in the last five.

425 As we stated in the Further Notice, the APQC's communications index contains some non-telecommunications activities, such as broadcasting. Further Notice, 3 FCC Rcd 3403 (para. 372).

426 Id.

427 Id. at 3404 (para. 374). In our comparison of CPI indexes, we also found that in the 1975-1985 period, the differential increased to 2.64 percent per year.

428 Id. at 3404-05 (para. 377) and App. C.

tentatively concluded that our price cap formula should include a productivity adjustment.

204. Furthermore, we tentatively decided that a specific productivity number designed to estimate the future productivity differential could be selected and employed for some interval of time.[429] We tentatively rejected three proposed measures of productivity.[430] One was the Bureau of Labor Statistics' Total Factor Productivity (TFP) measure for the telecommunications industry, which we stated did not yet exist.[431] We also tentatively rejected the Bureau of Labor Statistics' Multi-Factor Productivity measure for Private Business, because it was too broad a measure, and thus did not reflect productivity gains in the telecommunications industry.[432] We also tentatively rejected use of the APQC index outlined above, because it includes economic activity extraneous to dominant carriers. In lieu of the measures proposed by commenters, we proposed a productivity factor of 2.5 percent, based on the long term studies of Bell System productivity, as well as our own analysis of AT&T cost and revenue changes since 1984.

ii. Pleadings

205. A number of parties have taken issue with our statements about the reliability of four-factor total factor productivity analyses, our characterizations of the historical productivity studies we examined, and our unwillingness to rely on American Productivity and Quality Center (APQC) data.[433] Many parties argue that the historical productivity studies we

---

429 Id. at 3406 (para. 382). In reaching this decision, we rejected arguments that we develop a measure of productivity gains each year, on the basis that such a procedure would be complex and controversial, and that selection of a specific number would be simpler, and would give carriers a benchmark from which they could target productivity gains. The productivity measure would, however, be reevaluated during the fourth-year performance review. Id.

430 Id. at 3406-07 (para. 383).

431 Those who urge us to use this measure are, in effect, asking us to delay this proceeding for several years or defer it altogther if BLS does not succeed in developing this measure.

432 We noted that the BLS's TFP was still under development and might not be in use until sometime in 1989. We also expressed concern about relying on a "new index until at least some experience is developed that satisfies concerns about its reliability." Id.

433 Parties also argue that our comparison of the overall CPI with the

examined are inherently flawed and unreliable indicators of future productivity because they do not reflect the productivity gains that will accrue due to technological improvements and recent capital investment that ratepayers have financed.[434] In addition, parties state that the historical studies must necessarily reflect the existence of the Averch-Johnson effect and X-inefficiencies, and therefore contain productivity numbers that understate what carrier productivity should be.[435] Other parties argue that these studies, which for the most part terminated in the late 1970's, are out of date.[436] MCI argues that the studies are inaccurate because they mask differences in the productivity associated with long distance service and local service.[437]

206. There is disagreement as to whether other types of productivity measures are valid. SWB agrees with our view that total factor productivity analysis is a superior productivity measure.[438] Ad Hoc argues that the best measure of telecommunications productivity is a single-factor labor

---

telephone sub-index of the CPI was flawed, although these arguments are made in the context of establishing a LEC productivity number. See BellSouth Comments at 29-30 (the sub-index of the CPI we employed includes local service, and the correct comparison should have been based on the GNP-PI series, which shows a 1.74 percent differential); NYNEX Comments, Coopers & Lybrand Report at 9-12.

434 Connecticut OCC Comments at 8, 10-11; Hawaii Comments at 6-9; IDCMA Comments at 11, 14-22; ICA Comments at 18-19; Florida's Citizens Reply at 9; TCA Reply at 17-19. See also UCC Reply at 2-4 (arguing that as to the LECs, carriers will reap the benefits of plant modernization under price caps that ratepayers have financed). Contra US Sprint Comments at 54-56 (arguing that the historical productivity studies we examined are the best available information on long term productivity). See also BellSouth Comments at 25-29 (asserting that as to the LECs, the historical studies cited in the Further Notice correctly come to the conclusion that productivity was around 2 percent.)

435 Connecticut OCC Comments at 11; ICA Comments at 18.

436 US West Comments at 59-61; Ameritech Comments at 18; Indiana UCC Comments at 16; NYNEX Comments at 54.

437 MCI Comments at 71.

438 SWB Comments at 7.

productivity measure,[439] while US West argues that single-factor measures will always overstate productivity.[440]

207. Parties also dispute our view that APQC data are less reliable because APQC employs a two-factor productivity analysis. SWB argues that the APQC data are entitled to substantial weight because they are relatively recent data (extending into the mid-1980s), and although they include broadcasting as a component of the index, broadcasting represents only a small portion of the economic activity reflected in the index.[441] SWB also argues that, based on an analysis of AT&T's own Bell System Productivity analysis, we should not be concerned that the APQC data are based on only two productivity factors. According to SWB, two-factor analysis tends to overstate, not understate, productivity.[442] SWB states that this Commission should adopt an eight-year moving average of the APQC index as our measure of productivity.[443] US West, in a proposal also supported by SWB, argues that the APQC index should be modified by taking out the broadcasting component to produce a telecommunications-only number.[444]

208. ICA, however, argues that the APQC data are flawed.[445] According to ICA, the APQC calculations contain an error that when corrected, raises industry productivity from -1.7 percent for the 1983-1986 time period, to 3.6 percent.[446] This criticism is sharply disputed by those who administer the APQC productivity index.[447] ICA also argues that carriers have not placed

---

439 Ad Hoc Comments at 31 n.23 & ETI Report at 32.

440 US West Comments at 65.

441 SWB Comments at 7-10; see also Bell Atlantic Comments at 16-18 (making a similar argument with respect to APQC data as a measure of LEC productivity in particular).

442 SWB Comments at 9-10; see US West Comments at 64-65.

443 SWB Comments at 10; SWB Reply at 26.

444 US West Comments at 63-64 & App. B; SWB Reply at 25-26.

445 ICA Reply, ETI Report at 3-5 & App. A.

446 Id.

447 See Letter from Noreen L. Preston, Consultant to the American Productivity and Quality Center to William Page Montgomery, Vice President, Economics and Technology, Inc., Sept. 1, 1988, filed in ICA Reply, ETI Report at App. A (stating there is no significant anomaly in the inputs used to calculate APQC data and criticizing ETI's methodology). ETI disagrees with

a sufficient amount of information in the record about the APQC index for any party or this Commission to decide whether it would be a suitable measure of industry productivity.[448]

209. A number of parties also contest our analysis of AT&T productivity in the post-divestiture period. In an appendix to its comments, AT&T submits a "corrected" version of our productivity study, that demonstrates a 1.8 percent differential between overall economic productivity and AT&T's productivity.[449] According to AT&T, the difference in its 1.8 percent figure and our 2.48 percent figure is largely the result of two corrections: (1) inclusion of private line rate changes; and (2) employing the correct amount of the impact of the Tax Simplification Act of 1987.[450] Similarly, US Sprint argues that our analysis did not take the following factors into account: (1) private line rate increases; (2) AT&T's underearnings; (3) a number of cost adjustments such as settlements, revenues associated with the flow through of gross receipts tax, and billing and collection costs; and (4) adjustments for certain exogenous factors. US Sprint argues that these factors would tend to lower AT&T's productivity number.[451]

210. Various other arguments are raised concerning the analysis relating to AT&T contained in the Further Notice.[452] Indiana UCC states that price

---

APQC's response, and argues that the APQC letter makes clear the difficulties in using short term productivity measurements. ICA Reply, ETI Report at App. A at 1-3.

448 ICA Reply, ETI Report at 5-6.

449 AT&T Comments at 44 & App. D.

450 Id. at 44-45. Contra CFA Reply at 8-10 (AT&T fails to include all of its services when calculating its productivity).

451 US Sprint Comments at 61-65.

452 ALC Comments at 14 n.11 (analysis regarding AT&T is flawed because it fails to account for the cost differences that would have existed had the LECs been subject to price caps); Indiana UCC Comments at 17-18 (Commission's analysis of AT&T prices reflects a post-divestiture time period different from that of the earlier historical studies, and therefore does not serve to corroborate them); New York DPS Comments at 14 (Commission's analysis did not measure productivity on a per unit basis and did not take into account expanding units of production); New York DPS Comments at 13-15 (the major regulatory changes underway in the 1984-1987 time frame make this period a poor indicator of AT&T productivity); Florida's Citizens Reply at 9 (concurring with the New York DPS). See also GTOC Comments at 31-32 (stating that, as measure of LEC productivity, the AT&T price analysis fails to take

comparisons such as the analysis of AT&T must assume, incorrectly, that regulators are completely successful in passing through productivity gains to ratepayers for the period under study.[453] Ad Hoc argues that our analysis utilizes a productivity concept that is inconsistent with our own definition of productivity in the Further Notice, and that is inconsistent with the definition that the BLS uses.[454] In addition, Ad Hoc argues that by using an average annual price increase in our calculations, we fail to account for a trend in declining unit costs over the study period.[455]

211. AT&T responds that the type of price comparison study performed by this Commission to determine the productivity level is better tailored to determine the productivity level needed to ensure consumer benefits. According to AT&T, such a "break-even" productivity factor analysis, which seeks to compute a productivity factor such that rates would have been the same under a price cap regime as they were under rate of return regulation, also eliminates the distortions that occur in a total factor productivity analysis due to possible differences between AT&T's input price changes and changes in economy-wide prices as measured by the GNP-PI. To the extent AT&T's input prices rise or fall at a greater rate than do prices as measured by the GNP-PI, a "break-even" productivity analysis will correct for this by giving a higher or lower productivity factor. Such an analysis will also correct for any double counting of exogenous cost factor changes in the GNP-PI and the explicit exogenous cost factor adjustment in the price cap formula.[456]

---

into account changes in the prices of the factors of production).

453 Indiana UCC Comments at 18.

454 Ad Hoc Comments at 17, 24 & ETI Report at 14. See also US West Comments at 65-66 (a price analysis such as this one has little to do with carrier productivity); IDCMA Comments at 12-13 (no correlation is established between prices and productivity).

Ad Hoc also argues that we have refused to discuss ETI's backcast comparison of industry price changes to price indexes, submitted in the pleadings leading up to the Further Notice. Ad Hoc Comments, ETI Report at 16-17 & App. A. Ad Hoc also states that we have incorrectly criticized the New York DPS' backcast analysis in the Further Notice. Id. at 17.

455 Ad Hoc Comments, ETI Report at 16. See also US Sprint Comments at 55-60 (if annual numbers are used instead of an average price change, productivity swings are substantial); Maryland PC Comments at 13-15.

456 AT&T Reply at 62-64.

AT&T, however, argues that a "break-even" analysis for the most recent period overestimates future productivity because demand growth experienced in the last four years will not be sustained in the future.[457]

212. In addition to taking issue with the studies that formed the basis for our productivity determination, a number of parties discuss the selection of the 2.5 percent productivity factor itself.[458] Several parties argue that our choice of a 2.5 percent factor failed to reflect accurately the historical productivity studies that we cited. These parties state that the productivity number we selected understates the rising trend of productivity that the studies reveal.[459] Ad Hoc states that since the studies upon which we relied display a clear and rising trend in productivity, our reliance on 30-year averages is misplaced.[460] Ad Hoc and other parties favor a 4 percent productivity factor for AT&T to reflect more recent productivity experience.[461]

213. Parties also argue that future productivity gains must be taken into account, and that current trends demonstrate higher future

---

457 Id. at 64-65.

458 Several parties argue that we have not supported our selection of a productivity factor. Arkansas PSC Comments at 3; IDCMA Comments at 13; Indiana UCC Comments at 15; Missouri PSC Comments at 9-10; Alabama PSC Reply at 2; API Reply at 2; DC OPC Reply at 10-11; NARUC Reply at App. C.

459 Ad Hoc Comments, ETI Report at 14; Indiana UCC Comments at 17; ICA Comments, BRI Report at 52-54; New York DPS Comments at 10-11; Maryland PC Reply at 11-12; DC PSC Comments at 14; Hawaii Comments at 6-7.

460 Ad Hoc Comments, ETI Report at 15-16.

461 Ad Hoc Comments at 26-27, ETI Report at 7 (arguing that use of 3 percent productivity offset means that consumers will lose $6.7 billion in the first few years of price cap regulation); ICA Comments at 20; CFA Reply at 9; TCA Reply at 19. See also Florida PSC Comments at 4 (productivity number is too low).

productivity.[462] CFA and others argue that productivity should capture the declining costs experienced in the interexchange business.[463] IDCMA states that the continuing trend toward an increase in demand will continue to lower unit costs in the future.[464] Ad Hoc argues that a price backcast of pre-1984 rates demonstrates that productivity for a composite of interstate toll and total private line has been 3 percent, but that productivity will rise due to technological changes and the elimination of the Averch-Johnson effect.[465]

214. Consumer groups argue that the structural changes in the industry that have occurred in the 1984-1987 time period, especially divestiture, have depressed productivity.[466] They argue that selecting a productivity number for AT&T based on this time period would result in too low a productivity

---

462 See IDCMA Comments at 13 (stating that there is no reason why the productivity experience of the past four years will be repeated in the future); but see MCI Comments at 71 (future cost trends are more relevant than historical trends, and future trends will cause productivity to decrease).

463 CFA Comments at 10; API Comments at 8-9; Hawaii Comments at 6-9.

464 IDCMA Comments at 22-23. See also ICA Comments, BRI Report at 42-45 (arguing that the type of regulation applied does not affect cost savings as much as the effect of declining costs).

465 Ad Hoc Comments at 31-34 and ETI Report at 34-36.

466 CFA Comments at 13; UCC Reply at 4-5. The Maryland PC, conducting its own price analysis of industry rates, asserts that if our proposed price cap plan had been in effect from 1979 to 1985, consumers would have been $5.7 billion worse off than if carriers were regulated under rate of return. Maryland PC Reply at Appendix. However, the Maryland PC analysis mistakenly applies the inflation minus productivity adjustment to all costs, rather than just to non-access costs, as our formula does.

offset.[467] CFA states that before adopting a price cap method, we should permit these structural changes to come to completion.[468]

215. Other arguments that our 2.5 percent factor is insufficient are also made. Indiana UCC argues that the 2.5 percent factor does not reflect recent changes in competition, the effects of divestiture, and technological innovation.[469] According to Indiana UCC, AT&T's productivity could be as high as 4 to 5 percent, without the CPD.[470] Ad Hoc states that we should have placed substantial weight on the Christiansen study submitted in the AT&T divestiture trial, which it asserts shows a 3.2 percent differential in productivity.[471] In addition, Ad Hoc asserts that aspects of our price cap formulas tend to reward carriers for growth in demand and revenues unrelated to efficiency, and that this tendency should lead us to establish a higher productivity number than we have proposed.[472] Ad Hoc argues that the selection of a productivity number is all-important, since if the number we choose is too low, the CPD will be illusory, and if the number is too high,

---

467 CFA Comments at 13; UCC Reply at 4-5. CFA also provides data from the APQC demonstrating that productivity gains in the "Electrical Machinery" and "Instruments" sectors did not trail off after 1984, while the communications sector did. CFA Comments at 15. See also Indiana UCC Comments at 16-17 (arguing that we should consider the productivity experience of other, related industries). NYNEX, however, warns against employing productivity calculations from related industries. According to NYNEX, productivity gains from the electronics industry, for example, are factored into the GNP-PI. NYNEX Comments at 23 n.27.

468 CFA Comments at 14.

469 Indiana UCC Comments at 16. See also IDCMA Reply at 5 n.12 (carrier investment and operating experience should be examined, along with technological developments, to determine a productivity number).

470 Indiana UCC Comments at 18-19. Accord New York DPS Comments at 11-12 (productivity ought to be significantly more than 2.5 percent, and should increase over time).

471 Ad Hoc Comments, ETI Report at 15. Ad Hoc notes that the 3.2 percent differential was recently confirmed with a study presented at a meeting of the International Telecommunications Society. No copy of this study was submitted in the record in this proceeding. Id. at 15.

472 Ad Hoc Comments, ETI Report at 16.

carriers will not elect price caps.[473] ALC provides six criteria that a productivity factor should meet to be acceptable.[474]

216. Arguments are also made that the productivity number proposed in the Further Notice is too high.[475] AT&T states that the experience of the last four years is not a good predictor of the future because the growth in demand that has been experienced will not continue.[476] AT&T argues that, at a maximum, the productivity number should be set at 1.8 percent, representing the "corrected" differential AT&T found in its own price comparison analysis, discussed above.[477] NYNEX states that the industry is exhibiting less productivity gains of late than it has previously.[478] NYNEX, based on a comparison of the BLS Private Business Sector index and the Christiansen study, argues that the long term differential is actually 1.5 percent for the industry.[479]

---

473 Id. at 17-19. Ad Hoc argues that under the proposed plan, actual productivity must be between 2.5 percent and 3 percent for consumers to benefit. Id. See also ICA Comments, App. B (BRI Report) at 14-19 (arguing that if the productivity number is not correct, price caps will not produce better results than rate of return).

474 These are: (1) the measure must be specific to the industry or to the price cap regime; (2) it must be accurate in measurement of variables and concepts reflected in price cap regulation; (3) it must be readily available on a reasonably current basis; (4) it must be calculated and published by a neutral source to which the Commission staff has access; (5) it should be easy to calculate and straightforward to explain; and (6) it should be widely accepted for use by government and business, and if possible, in academia. ALC Comments at 15-16. However, ALC does not suggest an index that meets these criteria.

475 E.g., CCIA Comments at 12. But see Ohio PUC Comments at 15 (finding nothing wrong with the 3 percent factor).

476 AT&T Comments at 45-46. See also US Sprint Comments at 57-60 (noting that demand growth and cost-cutting measures by AT&T cannot be sustained at present rates).

477 AT&T Comments at 48.

478 NYNEX Comments at 25.

479 Id., Coopers & Lybrand Report at 4-6.

217. AT&T takes issue with the ETI Report's conclusion that the historical studies we cited demonstrated rising productivity.[480] According to AT&T, ETI employed total growth, instead of net growth relative to the economy as a whole, in reaching its conclusion, as well as commiting other analytical errors.[481] NYNEX also contests whether the "rising trend" in productivity found in the historical studies we cited is anything more than the effects of a normal business cycle that will eventually reverse.[482] According to NYNEX, the rising trend detected by ETI and others is actually more related to the overall weakness of the economy during that time period, and therefore overstates telephone industry productivity.[483] SWB states that arguments that technology is resulting in greater productivity gains have not been supported with evidence, and should therefore be discounted.[484]

218. A number of parties also point to the recent announcement from the United Kingdom that its regulatory agency, Oftel, had increased British Telecom's productivity offset to 4.5 percent from 3 percent.[485] Several parties charge that the British experience demonstrates that our 2.5 percent factor is too low.[486] Maryland PC argues that it lacks credibility to adopt a productivity offset lower than Oftel's since U.S. industry is much more productive than industry in Great Britain.[487] SWB, however, argues that

---

480 AT&T Reply at 58-62.

481 Id. For example, AT&T argues that by focusing on average industry results from 1966-1978, ETI is drawing from a time period that is likely to have limited relevance to today's situation. AT&T also argues that the historical studies fail to distinguish between local and toll activity, and are of limited use in establishing AT&T's productivity factor.

482 NYNEX Comments, Coopers & Lybrand Report at 7-8.

483 NYNEX Reply at 33-34.

484 SWB Reply at 30-31.

485 CFA notes that the carriers in this proceeding have generally been silent on this issue. CFA Reply at 10.

486 CFA Comments at 16; Hawaii Comments at 9 n.12 (arguing that Oftel examines projected costs in its determinations); IDCMA Comments at 24-25 (Oftel looks at future trends); TCA Comments at 17; Wisconsin PSC Comments at 7; Hawaii Reply at 3 n.5. See also EDS Comments at 3 (arguing that the 2.5 percent figure is too low and citing the British experience).

487 Maryland PC Comments at 16.

these parties are confusing productivity levels with productivity gains.[488] AT&T argues that a higher percentage of British Telecom's costs are recovered by non-usage based rates and that British Telecom faces lower minute growth and higher line growth than does AT&T. For these reasons, British Telecom's productivity factor is irrelevant to AT&T.[489]

219. Disagreement also exists concerning what effect competition should have on the selection of a productivity offset. AT&T argues that there is no need for a productivity offset for AT&T, since competition is sufficient to ensure efficient operations and lower rates for consumers.[490] MCI, agreeing with AT&T, argues that if price cap limits are too tight, competition will not allow AT&T and its competitors to later make up the deficiency.[491] US Sprint states that overly-tight caps will only interfere with competition and are not necessary to protect ratepayers.[492] BellSouth, however, argues that AT&T is subject to little price competition, and there is no reason to lower AT&T's productivity offset based on competitive circumstances.[493] Bell Atlantic argues that if competition holds AT&T's rates down, then the size of the productivity differential is irrelevant.[494] IDCMA and others argue that competition is inadequate to ensure that consumers will benefit.[495]

220. Some parties argue that, despite our efforts, it is impossible to determine productivity trends in the post-divestiture environment.[496] The

---

488 SWB Reply at 30.

489 AT&T Reply at 63 n.* & at 72 n.**

490 AT&T Comments at 46-47; see US Sprint Comments at 49-54.

491 MCI Comments at 71-72 & ICF Study at 3-5. ICF also states that since more of AT&T's costs are controlled in the federal arena, a mistake in the form of an excessive productivity offset could have a substantial impact on AT&T.

492 US Sprint Comments at 46-49. See also NTN Reply at 30 (agreeing that there is a danger in forcing prices down faster than AT&T's competitors can decrease costs).

493 BellSouth Reply at 38-41.

494 Bell Atlantic Reply at 15-16; see BellSouth Reply at 42.

495 IDCMA Reply at 5 n.12; Indiana UCC Comments at 20; New York DPS Comments at 15.

496 CFA Comments at 13; Florida's Citizens Reply at 8; New Hampshire PUC Comments at 26; Maryland PC Reply at 8.

ETI Report, for example, argues that all of the price analyses in the record contain errors and discrepancies.[497] API argues that we are adopting a productivity number based on secondary sources that are insufficient for this purpose.[498] Others argue that we should work toward developing a telecommunications-specific productivity index that is tailored to price caps.[499] US West suggests that we employ BLS's upcoming telecommunications index that they state will be available in 1989.[500] Several parties argue that, at minimum, we begin collecting the data necessary to determine a better productivity number in the future.[501]

iii. Discussion

221. As we stated in the Further Notice, an analysis of productivity must begin with a determination of whether the productivity of the telecommunications industry has exceeded that of the economy as a whole. Only if telecommunications productivity experiences greater gains than does the general economy is it necessary to include a productivity offset in our price cap index. Significantly, no party took issue with our tentative finding that, over the past 40 years, telecommunications productivity has exceeded that of the general economy by about 2 to 3 percent, with slightly lower values characterizing earlier periods of time.[502] Parties did take issue, however, with whether the historical experience is relevant to AT&T's current productivity. In addition, parties are divided over what measure of productivity will best reflect current experience, and concerns are also expressed about our own analysis of AT&T productivity since divestiture. Based on our review of the record, we affirm the tentative findings we made on these issues in the Further Notice, and conclude that AT&T's productivity factor should be set at 2.5 percent, exclusive of the Consumer Productivity Dividend.

---

497 ICA Reply, ETI Report at 10.

498 API Comments at 5-8.

499 CFA Comments at 11-13 (arguing that we should work with BLS); ALC Comments at 6; ICA Comments at 21; DC OPC Reply at 11-12; Indiana UCC Reply at 12-13.

500 US West Comments at 66-67.

501 API Comments at 9; IDCMA Comments at 48-49; Indiana UCC Comments at 19. The Oregon PUC expresses the general concern that much of this information will not be in the public record. Oregon PUC Reply at 10.

502 Further Notice, 3 FCC Rcd at 3403 (para. 373).

222. In selecting a productivity offset for AT&T, we have determined that long term historic productivity for the industry has fallen within a narrow range of 2 to 3 percent. We have evaluated a number of other studies and productivity measures. We have also calculated a measure of AT&T productivity for the post-divestiture period, and found productivity gains of 2.3 percent per year. Based on the totality of the evidence, we determine that, regardless of short term or year-to-year changes, AT&T is likely to experience productivity gains on the average of 2.5 percent a year. We therefore set 2.5 percent as the productivity offset to be employed in our price cap formula.

223. The historical productivity studies we cited in the Further Notice served two purposes in our determination of a productivity factor. First and most importantly, they were the foundation of our finding that telecommunications productivity exceeds that of the economy as a whole. Second, the results of these historical productivity investigations served as evidence of a 2.5 percent productivity factor. Many parties argue that, for different reasons, the historical productivity numbers do not reflect current productivity experience. Some parties have claimed that historical productivity studies are flawed because they do not take into account imminent productivity gains that will result from recent technological improvements, while others claim productivity in the future will be lower because the productivity gains from technological improvements have already been generated. None have provided convincing quantitative measures of what future productivity gains will be. As evidence for their claims, these parties discuss a number of relatively new technologies, such as digital switching and fiber optics, that they claim will raise or lower productivity in the future. We are not convinced that productivity in the future will be substantially higher or lower than the level reflected in the historical studies. We continue to believe the most accurate predictor of AT&T's expected future productivity is long term historical productivity. We recognize that historical productivity may be distorted by the Averch-Johnson effect and X-inefficiencies, and might for that reason not reflect future productivity completely accurately under a price cap regime. Price caps give the carrier an incentive to squeeze out these inefficiencies and improve its productivity in the long run. In addition, these distortions more obviously affect the level of achieved productivity, than its year-to-year change. The productivity factor can be adjusted at the time of the fourth-year performance review if it becomes evident that an adjustment is warranted due to improved efficiencies we expect price caps to elicit.

224. In addition, we note the inherent complexity of attempting to determine a productivity number based on predictions of future trends. Our use of a number that is grounded in long term historical experience reflects our belief that, while productivity may change from year to year in response to a number of factors, a long term average bears a closer relationship to the level of productivity in the future than will contemporary efforts of prediction. This is particularly important in view of the massive

technological change that has swept the industry over the last 20 years, and that is likely to continue into the foreseeable future. We also note that even under rate of return regulation we must make an implicit assumption about productivity in deciding on each tariff, a much more difficult undertaking than predicting overall productivity as we are for price caps.[503]

225. The studies examined in the Further Notice were for the most part of pre-divestiture Bell System data. As many commenters point out, use of productivity data from before divestiture may result in a less than perfect productivity determination for a divested AT&T, since the historical studies reflect a unified Bell System. We agree, and for that reason we do not rely on them exclusively. However, the studies are corroborated by other measures of productivity we have examined in reaching our 2.5 percent productivity offset.[504]

226. In addition to our previously cited studies, at least two additional economic analyses should be noted. Kendrick's study of AT&T's two-factor productivity concluded that it averaged 4.9 percent between 1948 and 1979.[505] Compared to the economy-wide average of 2.0 percent that he reports, this implies a differential of 2.9 percent. Since, as we explain below, two-factor productivity tends to be slightly larger than three-factor or four-factor productivity, this result is consistent with our findings.

---

503 Under our current system of rate of return regulation, rates are set based on a prospective test year, i.e., based on forecasted cost and demand data. These forecasts implicitly require a forecast of productivity growth to determine test year costs for services. Thus, for each tariff filing, we make an implicit assumption about productivity.

504 NYNEX argues that the Christiansen study we identify demonstrates a productivity differential of 1.4 percent, not the 2.1 percent we cite. NYNEX computes this productivity differential by employing the BLS' economy-wide total factor productivity number in lieu of Christiansen's own economy-wide total factor productivity number. Substitution of different measures of economy-wide productivity, however, will tend to skew the productivity differential since a different economy-wide number may not be well suited to the specifics of the study. We cite the telecommunications productivity differential that Christiansen reports, without manipulating his findings by substituting other measures of industry productivity. Moreover, since we do not rely exclusively on the Christiansen study for our productivity numbers, we do not find that NYNEX's argument warrants selection of a lower factor.

505 J. Kendrick, Improving Company Productivity 87, 102 (1984).

227. In addition, Denny, de Fontenay, and Werner provide an analysis of Bell of Canada productivity that separates out provincial exchange service.[506] For the years 1967-1979, they calculate average total factor productivity increases of 3.2 percent per year, a firgure representing Bell Canada's productivity growth, without netting out overall economic productivity growth. As we noted in the Further Notice, the manifold differences in the environments in which telecommunications operates in the United States and in Canada makes direct comparison hazardous, but it seems apparent that productivity there nonetheless does not differ greatly.

228. In addition to evaluating historical studies, we also evaluated a variety of other productivity measures and indexes to determine if any could be used as our productivity offset. As we stated in the Further Notice, some of the measures parties urge us to employ have a tendency to either understate or overstate telecommunications productivity. For example, some parties favor use of the labor productivity measure for the telecommunications industry which is published by the Bureau of Labor Statistics. As others rightly point out, a labor productivity measure, as a single factor measure, will tend to overstate productivity. This is so because increases in the productivity of one input can be made by giving that input -- in this case, labor -- more of other inputs to work with. However, such a practice does not necessarily yield the most efficient use of resources, and the productivity number will be overstated. We also reject use of the two-factor index for telecommunications developed by the American Productivity and Quality Center (APQC) by which to mark productivity gains into the future. As a general matter, any two-factor index such as APQC's will tend to overstate true productivity.[507] Furthermore, the APQC index also includes data for segments of the broadcasting industry. Even if the broadcasting industry data is

---

506 M. Denny, A. de Fontenay & M. Werner, Comparing the Efficiency of Firms: Canadian Telecommunications Companies in Economic Analysis of Telecommunications, L. Courville, A. de Fontenay & R. Dobell, eds. (1983).

507 As we previously noted, however, APQC's index, averaged over the 1948-1985 period, shows an annual industry advantage in productivity of 2.2 percent, slightly lower than the 2.5 percent factor we select. One of the factors contributing to the 2.2 percent average is that the APQC index indicates a recent drop in productivity gains since divestiture. The APQC itself has been unable to pinpoint a cause for the recent downturn in its index. See ICA Reply at Exh. A (ETI Report), App. A. Furthermore, the productivity decline reported by APQC does not appear in other measures of industry productivity we have consulted. While we are unable to explain why a two-factor measure such as APQC's would arrive at a value on the low end of the range of productivity gains reported elsewhere, we nonetheless believe that the 2.2 long term average to some extent confirms our view that industry productivity exceeds that of the economy as a whole by 2 to 3 percent.

removed, as US West proposes, we still reject use of this productivity measure because it is a two-factor index.[508]

229. We find further support for our selection of a 2.5 percent productivity factor in our comparison of the overall Consumer Price Index (CPI) with the CPI sub-index for telephone services, both local and long distance. As we stated in the Further Notice, over the period 1935-1985, the price differential is 2.25 percent. As in the pre-divestiture studies we cite, this differential does not distinguish local from long-distance service. Nevertheless, it corroborates the results of those historical studies.[509]

230. Some commenters claim to discern a clear and rising trend in productivity in the 10-year period before divestiture. These trends are evidenced in the pre-divestiture Bell System data from the studies analyzed in the Further Notice. We did not, and do not, dispute the existence of these trends in these data.[510] We do not conclude, however, that we should rely

---

508 We also find that measures of productivity submitted by Ameritech and NTIA do not alter our conclusions about industry productivity generally. Ameritech, which studied its total operating expenses adjusted for growth in access lines, found productivity growth of -.7 percent for the 1975-1987 period. Ameritech's exclusive focus on total expenses, however, fails to consider the productivity impact of investment decisions, and also fails to isolate and remove local exchange and nonregulated functions. In addition, the selection (as the measure of output) of interstate access lines, which are only a part of total company output, is inconsistent with the much broader measure of inputs, total company expenses, employed in the Ameritech study. NTIA's reference to Michigan Bell's productivity performance from 1980-1983, claiming a differential of 1.3 to 2.3 percent, is too oblique to permit evaluation.

509 NYNEX substitutes the GNP-PI for the CPI, and finds a price differential of 1.5 percent. This comparison is not valid because it compares a consumer measure, the CPI sub-index, to a total economy measure, the GNP-PI. For a valid comparison to the GNP-PI, we would need a telephone service sub-index of the GNP-PI that reflected the basket of telephone services purchased by the sectors of the economy reflected in the GNP-PI, not just the consumer sector of the economy.

510 Nevertheless, the ETI Report's conclusion that productivity has been rising is based on a flawed examination of the evidence. The studies ETI examines are: (1) the study in the Christensen testimony, which gives a differential of 3 percent; (2) the study in Bell System Productivity Study 1947-78, which computes a differential of 3 percent; and (3) the Nadiri and Schankerman study, which computed Bell System productivity to be 4.96 percent. The third study it cites gives data only for the Bell System, not for the

exclusively on data from this time period for the development of our productivity factor. From 1947 to 1979, the differential of Bell System productivity over economy-wide productivity both rose and fell. It is not clear that the rise in the productivity differential over the last years of that period indicated that AT&T's productivity would be higher than the long run average from 1979 on. There is no convincing evidence that any particular sub-period represents precisely the right benchmark for future productivity gains. Indeed, our own analysis of AT&T's post-divestiture productivity cautions against too extreme a view of likely future gains. Moreover, at least part of the recent increase in relative telecommunications productivity change was due to a decline in economy-wide productivity in the 1970s, a decline that has now been arrested and perhaps partially reversed.

231. For such reasons, relying exclusively on a few studies' reading of recent productivity gains (i.e., those recorded in the 1970's or 1980's) is not likely to represent the best prediction of future gains. Yet we are sufficiently impressed with the apparent trend to make some accomodation in the determination of the productivity factor for AT&T. Therefore, we believe that a 2.5 percent productivity differential represents the appropriate middle ground between somewhat lower estimates for earlier periods and (by some measures) slightly greater values for some more recent years.

232. To help fill in the gap in reliable analysis of AT&T productivity in the post-divestiture period, the Commission analyzed AT&T productivity by evaluating cost and price changes that AT&T has experienced since divestiture.[511] Our analysis of AT&T's productivity since divestiture is intended to provide further evidence of the level of the productivity differential, and will capture the effects, if any, of recently increased or decreased productivity. The methodology for our analysis was outlined in Appendix C in the Further Notice. The theory underlying this analysis is as follows. In the simplest case, an evaluation of carrier productivity by price and revenue data would assume no exogenous costs and no inflation. Only direct costs of production controlled by the carrier and subject to rate of return regulation would be considered. In this case, total carrier revenue equals total carrier cost. Any change in the price a carrier charges between two periods is then due to a cost change that is incurred by the carrier,

---

differential between the Bell System and the entire economy. The average for the other two studies shows Bell System productivity for 1966 to 1978 was 3.0 percent.

511 Our original study appeared as Appendix C to the Further Notice. In this Order, we revise the data we originally used, and calculate a slightly different result. The revised productivity analysis appears as Appendix C to this Order. The adjustments made in Appendix C to AT&T costs are based on data from various AT&T tariff filings, as referenced in Appendix C.

recognized by the regulator, and reflected in price so as to maintain normal profits. If the carrier experiences a productivity gain of X percent between the periods, effective rate of return regulation will lead to a price decrease of exactly X percent. Alternatively stated, if price decreases by X percent, unit cost may be presumed to have declined by that percentage.[512]

233. The actual case is somewhat more complex. First, general inflationary factors over time also give rise to regulatory approval for price increases. Those price increases that exactly match overall inflation do not represent productivity changes, but simply reflect the changed value of money. Therefore, the real cost change will be the price change net of an index of inflation. Second, in our price cap plan, changes in certain exogenous costs are not indexed, but rather are flowed through directly to prices. To this extent, the change in exogenous cost should be netted from any price change before calculating the inflation and productivity factors.

234. In this analysis, the result of which is outlined in Appendix C of this Order, we compute changes in AT&T's revenues and costs since 1984. The analysis in the Further Notice failed to reflect all AT&T price changes, and considered only access charge changes. Appendix C of this Order computes AT&T's productivity by this same method, but includes all AT&T's price changes since 1984, and adjusts costs for several exogenous cost changes that were not reflected in the analysis in the Further Notice. This analysis indicates that AT&T productivity was 2.3 percent from 1984 to 1988.[513]

235. We are not persuaded to lower the value of the offset to 2.3 percent in recognition of our findings of AT&T's productivity during the past four years. As we have previously indicated, productivity measures over short time periods are of less value than longer term averages. While our study corroborates the productivity factors calculated by others, it cannot be

---

512 This analysis does not assume that rate of return regulation was perfectly effective throughout the period. Indeed, we believe the contrary. Rather, this analysis assumes only that rate of return represented an equal degree of efficacy during the period in question. Use of productivity measured in this manner guarantees that price caps will be at least as effective in passing through productivity gains as was rate of return regulation. Moreover, under the plan we adopt for AT&T, the Consumer Productivity Dividend will increase the gains passed through. Nor do we find that our analysis of post-1984 AT&T productivity, which measures implied productivity from price and cost data, is flawed. Price data, as well as quantity data, can be used to compute productivity.

513 In calculating its 1.8 percent productivity factor, AT&T omitted some amortization costs, and averaged the net changes over four years instead of five.

viewed as the only source of information about AT&T productivity. Our own study is simply another piece of information, which, together with the pre-divestiture studies and other measures we have evaluated, enables us to select an offset from a narrow range of choices.

236. We are not convinced by AT&T's argument that, because there has been a large growth in demand since 1984 that AT&T argues will not continue, its productivity in the future will be lower. Since the 2.5 percent productivity growth is consistent with long run (1947-79) productivity growth in the Bell System, it appears that this level should be sustainable under a wide range of situations. There were also a great many problems associated with divestiture which may have led to nonrecurring costs that lowered AT&T's short term productivity following divestiture.

237. The recent increase in the productivity factor used to adjust British Telecom's price caps, from 3 percent to 4.5 percent, has no direct bearing on the proper productivity factor for AT&T. British Telecom began its price cap program as a newly privatized provider of local and long distance service and as such may have had more room to make initial productivity gains. British Telecom also operates under a completely different institutional structure. For these reasons, its productivity factor is irrelevant in determining the factor for AT&T. It should also be remembered that British Telecom is now in its second "round" of price cap regulation, in which the revised benchmark reflects the success achieved during the initial period.

238. Nor do we believe that competition for AT&T's services renders a productivity offset entirely unnecessary. If competition were sufficiently strong to force AT&T to pass through any productivity gains in the form of lower prices, then AT&T should be classified a non-dominant carrier. This Commission continues to view AT&T as dominant. Therefore, given that AT&T is more productive than the economy as a whole, it is necessary to include a productivity adjustment in its price cap as an additional safeguard for ratepayers.[514]

---

514 We do not agree with Ad Hoc's assertion that our price cap formulas reward carriers for growth in demand and revenues unrelated to efficiency. Specifically, they claimed our actual price index (API) ignores demand stimulation effects and is therefore understated, and our exclusion of new services from the cap for two years also leads to an understatement of the API. However, the quantities used in weighting our API are updated every year and therefore do reflect demand stimulation. It is also impossible to include new services in the API until some quantity of the new service is sold. During the period before new services are incorporated into the API, earnings on the new services are constrained by a net revenue test just as they are under our current rate of return regulation.

239. We are also not persuaded to adopt a BLS index of telecommunications productivity that is currently under development. The BLS telecommunications productivity index does not at present exist and it is not clear when the index will be established.[515] Once the index becomes operational, however, we will examine it carefully to determine if it can be used in the price cap system we are adopting. We are also not convinced that developing our own index to measure productivity is a preferable alternative. Not only would we have to compute an index for AT&T or the telecommunications industry, but we would also have to develop a comparable index for the entire economy to enable us to compute the productivity differential. Such a burdensome undertaking is not required. Data are available that provide a more than sufficient basis for determining a reasonable productivity factor.

c. Consumer Productivity Dividend

i. Summary of Further Notice

240. The Further Notice tentatively found that setting a productivity factor equal to historical productivity levels would not necessarily force carriers to share the efficiencies derived from incentive regulation with consumers. In order to ensure sufficient consumer benefits, we adjusted our view of carrier productivity upward by 0.5 percent.[516] We tentatively found that carriers would be able to generate productivity gains representing the combined total of our historical productivity factor of 2.5 percent and the 0.5 percent "Consumer Productivity Dividend."[517]

241. We also requested comment on two alternative proposals affecting the Consumer Productivity Dividend (CPD). First, we asked parties to comment on a plan to reduce price cap indexes by 2 percent, representing the cumulation of four years of the CPD, at the time the price cap plan becomes effective.[518] The productivity factor included in the formula calculation would then be reduced to 2.5 percent per year.[519] We also requested comment

---

515 Our latest discussions with BLS staff indicate that this index will not be ready in 1989, due to difficulties in collecting data.

516 Further Notice, 3 FCC Rcd at 3407-08 (para. 386).

517 Id. at 3408 (para. 387).

518 Id. at 3337 (para. 258).

519 Id.

on the need to apply the CPD to AT&T's rates.[520] We sought comment regarding whether we could rely on competition to force AT&T to pass efficiency gains on to consumers.[521]

ii. Pleadings

242. A number of parties approve of our idea of employing a CPD mechanism to require carriers to share efficiency gains with consumers.[522] Ad Hoc and CCIA argue that the goal of the CPD is sound.[523] Carriers state that the CPD effectively operates as a guarantee that inflation-adjusted price reductions will exceed the historical average experienced under rate of return.[524] Furthermore, two parties conclude that the 0.5 percent CPD is the correct adjustment to be applied to AT&T's productivity factor.[525]

243. Others express concern with the size of the CPD, particularly in relation to the productivity factor.[526] Alabama PSC argues that the proposed CPD will not benefit consumers, who have already paid for a number of technological advances under rate of return, echoing an argument made with regard to the productivity factor.[527] IDCMA states that the proposal limits consumer benefits to 0.5 percent per year at a time when carrier costs are falling.[528] New Hampshire PUC argues that the CPD is a transparent attempt to make our formula adjustment plan like the one in effect in Great Britain.[529]

---

520 Id. at 3408 (para. 389).

521 Id.

522 GTOC Comments at 31; NYNEX Comments at 23; United Comments at 5; CFA Comments at 16-17; SWB Comments at 5, 11; US West Comments at 12-14.

523 Ad Hoc Comments at 16; CCIA Comments at 4.

524 BellSouth Comments at 12; NYNEX Comments at 35-36; Pactel Comments at 5; BellSouth Reply at 2; Pactel Reply at 2.

525 Ad Hoc Comments at 35-36; Ohio PUC Comments at 15-16.

526 See Arkansas PSC Comments at 3 (finding no justification for the 0.5 percent CPD).

527 Alabama PSC Comments at 2.

528 IDCMA Comments at 3, 10-11. See also Hawaii Comments at 9 (arguing that there is no basis to conclude that the CPD will result in rates lower than rates that would have been obtained under rate of return).

529 New Hampshire PUC Comments at 25-26.

Other commenters state that the CPD is too low.[530] CFA argues that the CPD for AT&T ought to be 1 percent.[531]

244. Other parties warn that increasing the CPD may ultimately prove counterproductive. BellSouth argues that there is a danger in tipping the balance too strongly in consumers' favor, thereby resulting in a suboptimal incentive structure.[532] US Sprint also argues that the CPD must not constitute retroactive ratemaking, and therefore should not be viewed as a vehicle for squeezing out rate of return inefficiencies.[533] Pactel argues that the CPD is a fair balancing of ratepayer and carrier interests, since carriers can benefit from price caps only if they experience productivity gains in excess of 3 percent.[534]

245. AT&T argues that no CPD should be applied to its rates since competition can be relied upon to ensure that ratepayers obtain lower rates.[535] The New York DPS responds that if it is true that AT&T's rates are set by the market, then the CPD is a costless insurance policy.[536] The Indiana UCC is also opposed to exempting AT&T from the CPD on the basis that AT&T retains substantial market power.[537]

---

530 EDS Comments at 12; New York DPS Comments at 16; TCA Comments at 18; NARUC Reply at 12, App. C.

531 CFA Comments at 17; CFA Reply at 9.

532 BellSouth Comments at 4. BellSouth also argues that the CPD should not be increased above its proposed level because the productivity factor we selected for dominant carriers overstates productivity, thereby resulting in a CPD substantially larger than 0.5 percent. BellSouth Comments at 15-16. See also US West Comments at 10-11 (making the same argument as to actual LEC productivity levels).

533 US Sprint Comments at 50 n.27.

534 Pactel Reply at 14-15. See also US West Reply at 24-26 (arguing that it is not realistic to divide the productivity offset into a 2.5 percent productivity factor plus the CPD).

535 AT&T Comments at 47-48. See also US Sprint Comments at 49-54.

536 New York DPS Comments at 15.

537 Indiana UCC Comments at 20. See also Maryland PC Reply at 12.

246. With regard to the proposal to discount aggregate rates at the inception of the price cap program instead of in each year, those parties who commented generally oppose such "up-front" rate cuts.[538] They argue that up-front cuts would require the company to pass through prospective cost savings it might never realize. They also argue that such cuts might push current rates below the zone of reasonableness and thus be confiscatory. New Hampshire PUC argues that a decision on whether to impose up-front cuts ought to be based on an analysis of what is actually happening with productivity.[539]

247. Four parties outline plans in use by the states to institute some form of incentive regulation that parties argue will benefit ratepayers as much, if not more, than the CPD and price caps.[540] The Connecticut OCC argues that its state commission sets a target rate of return above which carriers must share profits with consumers. The Connecticut OCC recommends that if we institute such a plan, all shared profits should be used to offset the monthly subscriber line charge.[541] The Colorado OCC proposes the retention of rate of return regulation and the use of regulatory lag and sharing of excess profits. According to the Colorado OCC, we cannot ensure that prices move toward long run average cost unless we enforce some system of cost-based regulation.[542] The Florida PSC has frozen rates at current levels and monitors data on market shares, rate changes below the cap, and financial results.[543] Similarly, the New York DPS has frozen rates and requires an even sharing of any excess profits which occur. The New York DPS argues that its system has advantages because regulators can evaluate whether carrier earnings are just and reasonable in each year.[544]

---

538 Bell Atlantic Comments at 20 n.42; BellSouth Comments at 16-17; Lincoln Comments at 4-5.

539 New Hampshire PUC Comments at 26.

540 Connecticut OCC Comments at 16-17; Colorado OCC Comments at 25-26; Florida PSC Comments at 4-5; New York DPS Comments at 38-47.

541 Connecticut OCC Comments at 16-18.

542 Colorado OCC Comments at 13-14.

543 Florida PSC Comments at 4; Florida PSC Reply at 2 & Appendix.

544 New York DPS Comments at 42-43. The New York DPS also disagrees with our assessment of its rate moratorium plan that we made in the Further Notice. Id. at 38-47. But see ICA Reply, App. C (critiquing the New York plan and arguing that a carrier can inflate its costs in order to avoid displaying earnings high enough to trigger the sharing mechanism).

iii. Discussion

248. To ensure that ratepayers are better off under price cap regulation, and to pass on directly to them gains resulting from efficiency improvements that we expect will result under a price cap system, we proposed to add the Consumer Productivity Dividend (CPD) of 0.5 percent to the productivity factor. The CPD ensures that consumers are the first beneficaries of added efficiency under price caps, since prices will be 0.5 percent lower than otherwise. Only after AT&T achieves this degree of efficiency will it be in a position to reap rewards. As a result, the CPD essentially represents a guarantee that under a price cap system, inflation-adjusted rate reductions will exceed the historical average under rate of return.

249. We remain convinced that a CPD of 0.5 percent provides the best balance of shareholder and ratepayer interests. This level represents a degree of added efficiency that appears achievable by AT&T, and will at the same time constitute a significant benefit to consumers.[545] No commenter has given any data supporting an argument that the CPD should be either higher or lower. There is good reason to avoid setting the CPD either too high or too low. If it is too low, ratepayers may not reap direct short run benefits from price caps in the form of lower rates. As we have previously discussed, competition for AT&T's services is not sufficient by itself to ensure that ratepayers receive an immediate benefit, absent the CPD.[546] If it is set too high, AT&T may be compelled to cut its prices below its costs, and thereby threaten its own profitability and disrupt the competitive forces that do exist. Thus, setting the CPD too high is not a costless insurance policy, as the New York DPS argues.

250. Furthermore, we find that the present discounted value of the CPD for the next four years should not be passed through in the form of up-front rate cuts. As several parties argue, such cuts might drive initial price cap rates below the zone of reasonableness. Also, by lowering the price cap each year, the CPD as proposed ensures that real prices will fall each year.

251. The alternatives to price caps proposed by several parties all provide somewhat weaker incentives to efficiency than do price caps, and may not generate as many consumer benefits. Most require some sharing of savings based on a carrier's performance, with consumers sharing in profits only after a carrier has managed to earn a targeted rate of return. A price caps plan for AT&T that includes a productivity factor in which we have a high degree of

---

545 The productivity adjustment ensures that ratepayers receive the same benefits from technological advances under price caps as they would have under rate of return regulation, and the CPD adds further protection for ratepayers.

546 See Section III.C.1.b, supra.

confidence and the CPD, not only gives AT&T an incentive to be as efficient as possible, but also ensures that consumers, not carriers, get their share of efficiency gains first. Relative to the proportional "sharing" mechanisms, the price cap system places consumers at the head of the line. Because the sharing mechanisms the parties propose may give lesser incentives to efficiency, they provide lower consumer benefits than our Consumer Productivity Dividend for AT&T. The parties that urge use of financial adjusters as a way of sharing productivity gains under price caps argue that the LECs, not AT&T, lack effective competition to restrain pricing and overall rate of return. Thus, they argue, the sharing mechanism in the financial adjusters is necessary as a protection for ratepayers. However, AT&T faces competition to varying degrees for some of its services, which provides a constraint on AT&T's prices and earnings. The protection for ratepayers provided by the financial adjusters is purchased at the price of reduced efficiency incentives. Although not strong enough by itself to protect ratepayers, the competition AT&T faces provides a measure of protection for ratepayers, and lets us avoid the reduced efficiency incentives which would result from using financial adjusters. In a later section of this Order, we discuss further the possible application of these sharing mechanisms to the LECs.

252. In addition, we reject suggestions that we simply freeze rates, with no adjustment for inflation or productivity. We find that rate freezes, while of some benefit to consumers, raise substantial legal concerns under our statutory system of carrier-initiated rates, and may not permit the carrier to recover legitimate cost increases. Rate freezes may also cause rates to depart from costs in a random and unpredictable manner.

d. Exogenous Costs

i. Summary of Further Notice

253. In the Further Notice we proposed that price cap levels should vary, not only in response to changes in inflation and to expected improvements in productivity, but also in accordance with changes in certain exogenous costs. We defined "exogenous costs"[547] as costs which change due to changes in laws, regulations, or rules, or due to other administrative, legislative, or judicial changes beyond a carrier's control.[548] We tentatively found that we must adjust the cap for such costs in order to assure that the price cap formula does not lead to unreasonably high or unreasonably low rates.

---

547 We also referred to these costs as "exogenous factors" and "Z costs."

548 3 FCC Rcd at 3383 n.738.

254. We proposed to treat the following as exogenous cost changes: changes in access charges paid by AT&T; changes in costs due to tax law changes; changes in the rate of flow-back of excess deferred taxes; changes in expense levels due to the expiration of current amortization programs; changes due to amendments to Part 36 of this Commission's Rules, the Jurisdictional Separations Manual;[549] and changes due to amendments to Part 32 of this Commission's Rules, the Uniform System of Accounts (USOA).[550] We proposed not to extend exogenous cost treatment to changes in depreciation expense caused by changes in depreciation rates, nor to changes in international accounting rates. In this section we first address several issues raised by the parties concerning theoretical and practical aspects of using exogenous cost factors to adjust the price cap. We then discuss the exogenous costs named in the Further Notice,[551] as well as several additional exogenous cost factors proposed by commenting parties.

ii. General considerations

255. Ad Hoc contends that our proposal to allow adjustments for a variety of exogenous cost factors will allow significant double counting of costs. By "double counting" Ad Hoc means that cost changes which affect the industry generally, and which are thus reflected in the GNP-PI, may also be treated as exogenous cost factors.[552] To avoid double counting, Ad Hoc suggests that carriers be required to petition for all exogenous cost adjustments except for adjustments to reflect changes in access tariffs. Such petitions, Ad Hoc argues, should be granted only if the carrier demonstrates that the cost change at issue is not reflected in the GNP-PI.[553]

256. We agree that we should not treat as exogenous cost factors those cost changes which are already adequately reflected in the GNP-PI. We do not, however, share Ad Hoc's belief that the only way to prevent double counting is to require a special showing each time a carrier seeks an exogenous cost adjustment. In our view, there are some types of cost changes which are imposed on the carrier by governmental action and which are unique to common carriers. These are not likely to be reflected in the GNP-PI, and therefore

---

549 47 C.F.R. §§ 36.001 et seq.

550 47 C.F.R. §§ 32.001 et seq.

551 We do not discuss here those exogenous cost factors which would apply only to local exchange companies.

552 Ad Hoc Comments at 29-30.

553 Id. at 37.

can be identified by type as exogenous. There are other types of costs which would ordinarily be reflected in the GNP-PI, but which might, under unusual circumstances, warrant exogenous treatment on a case-by-case basis. In our discussion, below, of the different types of costs for which we or others have proposed exogenous treatment, we include the question of possible double counting in our analyses.

257. Several parties raise questions about the manner in which exogenous cost changes are calculated. Michigan PSC Staff urges us to define the manner in which each exogenous cost adjustment is to be calculated, in order to assure that the formula will be uniformly applied.[554] DC PSC complains that the Further Notice did not adequately explain how we will assure that both direct and indirect benefits associated with changed regulatory requirements will be passed on to consumers. GTOC asks that we clarify the manner in which the return-on-investment component of an exogenous cost change will be calculated.[555] The calculation and allocation of exogenous costs are discussed in Section III.C.1.e., below. Consistent with the use of historical, rather than forecast, costs in our formulas, AT&T should use its actual rate of return on interstate investment during the base period to calculate the return-on-investment component of exogenous costs.

258. DC PSC argues that carriers should be required to forecast the value of any exogenous cost change which can be reasonably estimated in advance. DC PSC believes that requiring carriers to adopt preliminary estimates of exogenous cost adjustments is necessary to avoid jurisdictional cost shifting.[556] Pactel states that if a cost change clearly will occur

---

554 Michigan PSC Comments at 22.

555 GTOC Comments at 49-52. GTOC argues that our discussion of exogenous costs implies that we are referring to changes in revenue requirement and not merely to changes in expense. GTOC points out that, if we do intend to adjust for changes in revenue requirement, then we must provide a way to calculate the return component of that revenue requirement. GTOC notes as an example the recent Separations Manual change involving the use of dial equipment minutes. According to GTOC, 42 percent of the revenue requirement reduction associated with this change is due to return on investment and taxes. GTOC also argues that if exogenous cost changes are not intended to include return on investment, then they will not be fully captured. GTOC suggests that we continue to prescribe a rate of return for use in calculating exogenous cost changes, and that we continue to use the current prescription for the next four years or until we determine that represcription is necessary. Id.

556 DC PSC Comments at 11-13. The DC PSC states a particular concern that, if carriers are not held to forecasts of cost changes due to changes in jurisdictional separations rules, then joint boards which adopt separations

and accurately can be predicted, that change should be included for the period during which a tariff will be in effect. Changes which cannot be predicted should, according to Pactel, be included in the next annual filing after the changes occur.[557] As discussed at III.C.1.e.i., infra, our requirement that the PCI be continuously updated should address the concerns of these parties.

iii. Access charges

259. No commenting party opposes treating access charges paid by AT&T as exogenous costs, though a few express some skepticism about our assumption that access costs are wholly beyond AT&T's control.[558] ACTA and PRTC propose that AT&T be required to adjust the price cap for access charge changes quarterly, rather than annually. They believe that annual adjustments would foster predation in a time of falling access prices, while offering insufficient opportunity for cost recovery in the case of rising prices.[559] In addition, several parties argue that, in order to prevent AT&T from allocating access cost adjustments unfairly among its services, we should specify the manner in which AT&T must flow access cost changes through to particular services or rate elements.[560]

260. We adopt our proposal to treat switched and special access charges as exogenous costs. The rates which the LECs charge to AT&T for local exchange access are determined by tariffs filed by the LECs and reviewed by this Commission. Although actions taken by AT&T may have an impact on some of the costs which the LECs seek to recover through their access rates, the regulatory process through which this Commission decides whether to suspend, reject, or investigate an access tariff, or to allow it to take effect as filed, is beyond AT&T's control. Furthermore, because access charges are both unique to telecommunications companies and, for AT&T, very large, the impact on AT&T of changes in the price of access would not be adequately represented by the GNP-PI. For these reasons, changes in rate levels charged to AT&T for switched and special access will be considered as exogenous cost changes which trigger adjustments to AT&T's price caps.

---

changes might have to reinvestigate the dollar effects of their actions in later years.

557 Pactel Comments at 40.

558 See ACTA Comments at 12 n.12; Bell Atlantic Comments at 11-13.

559 ACTA Comments at 13-14; PRTC Comments at 23-25.

560 MCI Comments at 65-67; New York DPS Comments at 22-23; US Sprint Comments at 21; Cable & Wireless Reply at 14-15; MCI Reply at 26-27.

261. While we agree that there is a possibility that undue distortions in the relationship between AT&T's costs and its prices could occur if significant access cost changes were not passed through in a timely fashion, we do not agree that quarterly filings are necessary to avert this possibility. We believe it will be more efficient to address the necessity for midyear adjustments to AT&T's price cap index at the time that access charge changes are allowed to take effect. The allocation of access cost adjustments among AT&T's services is discussed in detail in Section III.C.1.e., below.

iv. Tax law changes

262. Summary of Further Notice. In the Further Notice we tentatively found that, because tax law changes are imposed by government action and not controllable by carriers, changes in tax liability due to changes in the tax laws should be flowed through to the price caps. We proposed that carriers use historical, rather than projected, costs in calculating the adjustment for tax law changes.[561] We also proposed that price caps should be adjusted in the event of a change in the rate at which a carrier is flowing back to the ratepayers excess deferred taxes.[562]

263. Pleadings. All carriers commenting on this issue believe that tax law changes should be treated as exogenous costs in calculating the PCI.[563] In support of this view, SWB asserts that exogenous treatment of tax law changes satisfies the two objectives of the exogenous cost adjustment. According to SWB, those objectives are (1) to maintain the relationship between price and cost; and (2) to hold carriers responsible for operational decisions and for the ordinary risks of doing business.[564]

---

561 3 FCC Rcd at 3215 (paras. 404-05).

562 Deferred taxes represent tax expenses which are deferred to a future accounting period pursuant to the tax normalization methods described in Section 32.22 of this Commission's Rules, 47 C.F.R. § 32.22. The Tax Reform Act gave rise to excess deferred taxes when it reduced the corporate tax rate. Because of this tax rate reduction, a portion of the deferred taxes which were included in the cost of regulated service prior to 1987 at the old rate will now never have to be paid. Pursuant to Section 203(e) of the Tax Reform Act, common carriers flow back these excess deferred taxes to ratepayers following the "average rate assumption method." That method spreads the return to the ratepayers of excess deferred taxes over a period of years which corresponds roughly to the life of the asset.

563 See, e.g., NYNEX Comments at 28; SNET Comments at 10; SWB Comments at 31; BellSouth Comments at 23.

564 SWB Comments at 31.

264. Ad Hoc, API, TCA, and DC PSC all oppose allowing an exogenous cost adjustment for changes in the tax laws. Ad Hoc, supported by TCA, argues that changes in the general tax laws affect all industries in a manner which directly affects the GNP-PI.[565] Therefore, according to these parties, allowing an exogenous cost adjustment for tax law changes constitutes double-counting. API adds that, in discussions with BLS, it was apprised that changes in tax laws are generally factored into indexes such as the GNP-PI.[566] DC PSC agrees that there may be double-counting and notes that, under our proposal, they might even be able to adjust rates for increases in social security taxes.[567]

265. Several carriers dispute the contention that tax law changes are reflected in the GNP-PI. BellSouth asserts that there is no a priori reason why a tax increase necessarily results in an inflation increase, and that the empirical question whether industry-specific or broad-based tax changes are determinants of changes in the GNP-PI has not been answered on the record in this proceeding. BellSouth also states that, because utilities traditionally serve as tax collectors for all levels of government, they are subject to a variety of assessments unique to the business world. BellSouth contends that this type of tax should continue to be passed on to ratepayers, just as it is under rate of return regulation.[568]

266. NYNEX argues that the claim of double-counting is incorrect because the GNP-PI does not reflect cost changes currently, but only after the economy has had a chance to react to those changes. According to NYNEX, a price cap formula which did not account for tax law changes on a current basis would result in improper market signals, including demand distortions and inappropriate reallocation of resources in the general economy.[569]

---

565 Ad Hoc Comments at 28; TCA Reply at 19 n.39.

566 API Comments at 24.

567 DC PSC Comments at 13.

568 BellSouth Reply at 56-57.

569 NYNEX Reply at 43. In NYNEX's view, allowing a separate exogenous cost change for tax law changes is no different from what happens in rate of return regulation. Under rate of return, carriers adjust rates to reflect tax changes; later, operational costs reflect the reaction of the economy to those changes. NYNEX believes that to change this policy would be "unduly burdensome ... and likely to require lengthy administrative procedures." Id. at n.73.

267. Pactel and USTA contend that Ad Hoc misunderstands the differing functions of the GNP-PI and the exogenous cost adjustments. They state that the GNP-PI accounts for general changes in the level of input prices faced by carriers, while the exogenous cost adjustment is for specific cost changes that would not be reflected in the GNP-PI. Thus, they claim, the effect of tax changes on price levels in the economy is reflected by the GNP-PI, but the change in a carrier's own tax liability is not reflected by the GNP-PI and must therefore be recognized through a separate cost adjustment.[570]

268. New York DPS seeks assurance that state and local tax law changes will also be treated as exogenous cost factors. In this regard, New York DPS contends that a recent repeal in New York of property tax assessments on central office equipment will, when fully implemented, reduce interstate telephone costs in New York State by about $60 million.[571]

269. Several parties seek amplification of certain aspects of our proposed treatment of tax law changes. BellSouth, Bell Atlantic, and NYNEX all ask us to make clear that carriers may "gross up" cost changes due to changes in income tax laws. They claim that the impact of tax cost changes must be calculated in this way in order to recognize a special characteristic of income tax expense, namely, that it is not tax deductible.[572] NYNEX and Bell Atlantic imply that if we do not allow them to gross-up tax cost changes when they calculate the PCI, we will cause them to violate depreciation and investment tax credit normalization requirements of the Internal Revenue Code. BellSouth simply urges us to "adjust [our] procedures and formulas accordingly, if necessary" to assure that carriers remain eligible for accelerated depreciation and investment tax credits.[573]

270. NYNEX also requests that we clarify that changes in tax liability are to be represented by changes reflected on the financial statement and not by changes reflected on the company's tax return. NYNEX states that calculating exogenous cost changes by using liability reflected on the tax return could cause any changes involving accelerated depreciation to flow through in violation of the Internal Revenue Code.[574] Finally, NYNEX asks us

---

570 Pactel Reply at 72-73; USTA Reply at 42-43.

571 New York DPS Comments at 21.

572 BellSouth Comments at 23 n.27; NYNEX Comments at 29-30; Bell Atlantic Reply at 7 n.15.

573 BellSouth Comments at 61.

574 NYNEX Comments at 29.

to confirm its understanding that tax costs include both current and deferred taxes.

271. Ameritech argues that we should also treat as an exogenous cost any increase in tax liability that a carrier might experience due to the general repeal of the investment tax credit. Ameritech states that as the pool of unamortized investment tax credits is amortized, the amount of tax expense reduction due to the investment tax credit will decline. Ameritech contends that, because the initial price cap rates will reflect past, higher levels of investment tax credits, the decline of the investment tax credit constitutes an exogenous cost increase which must give rise to an adjustment like that which we proposed for changes in the rate of flow-back of deferred taxes.[575]

272. Discussion. It appears that our proposal to treat tax law changes as exogenous was at once overly-simplified and too complex. We agree with the parties who contend that treating tax law changes of all sorts as exogenous would likely result in significant "double-counting" of cost changes already reflected in the GNP-PI. At the same time, we believe that if there are tax law changes which affect AT&T uniquely or disproportionately, and which are sufficiently large that endogenous treatment would render price cap rates unreasonably high or low, then those changes should be treated as exogenous cost adjustments. We therefore do not adopt our proposal. Instead, tax law changes will be presumed to be endogenous, but AT&T will be permitted to request exogenous treatment.[576]

273. An entity as large as AT&T, with employees and property spread throughout the country, is subject to many different kinds of taxes imposed by a multitude of taxing jurisdictions. These taxes change routinely from time to time, and are part of every company's ordinary risk of doing business. The overall effects of such tax law changes on prices are, to some extent, reflected in price indexes.

274. In one sense, BellSouth is correct that questions about how, to what extent, and when tax law changes are reflected in the GNP-PI are empirical questions which are, as yet, unanswered. However, BellSouth's implication that those answers could easily be discovered is not correct. The flow-through of corporate taxes to prices, and thus to price indexes,

---

575 Ameritech Comments at 34 n.16.

576 Failure by AT&T to propose exogenous treatment of an unusual tax decrease would provide reason for an investigation of AT&T's annual filing.

has long been a complex and controversial topic in the literature of public finance.[577] We cannot, and need not, resolve that debate here.

275. The parties who argue that the GNP-PI may reflect the impact of tax law changes on the prices AT&T pays for the goods and services it buys, but that it does not reflect the impact of those changes on the carrier's own tax expense, take too restricted a view of the GNP-PI and its role in our price cap formula. First, it is incorrect to view the GNP-PI as merely a measure of the costs of the things AT&T must purchase. As a very broadly based price index, it measures changes in all of the costs which affect prices in the economy. Tax costs are among that broad totality of costs. Second, we do not use the GNP-PI in our formula to represent the percentage by which each, or any one, type of cost faced by AT&T will rise or fall. Rather, it is used to indicate how AT&T's prices should be allowed to rise or fall in response to the rising and falling of all of its costs, whether paid to outside suppliers, to its own managers, workers, creditors and shareholders, or to the tax collector.

276. Since we are not adopting our proposal to treat tax law changes as exogenous cost adjustments, we do not discuss in detail all of the pleadings which addressed technical aspects of that proposal. We do note, however, that we never intended to place carriers in violation of the Internal Revenue Code, and that any exogenous tax changes which we do allow will be required to be calculated and applied in a manner consistent with the tax laws.

v. Separations Manual Changes

277. Summary of Further Notice. In the Further Notice we proposed to require adjustments to the PCI for changes in interstate costs due to changes in the Jurisdictional Separations Manual.[578] We proposed that such changes be calculated based on historical costs.

278. Pleadings. Almost all parties commmenting on this issue support our proposal. New York DPS, however, urges us to require prior approval by both this Commission and state regulators for changes which increase the allocation of costs to the intrastate jurisdiction. The Networks believe that jurisdictional separations changes may not affect the cost of providing jurisdictionally-interstate broadcast transmission service, and that the

---

577 See generally, R. Musgrave & P. Musgrave, Public Finance in Theory and Practice, Chs. 13, 14 & 19; The Changing Distribution of Federal Taxes: 1975-1990, Congressional Budget Office, Oct. 1987; A. Atkinson & J. Stiglitz, Lectures on Public Economics.

578 Part 36 of this Commission's Rules, 47 C.F.R. §§ 36.1 et seq.

adjustment for separations changes should therefore be calculated separately for that service.[579]

279. Colorado OCC urges that we accord exogenous cost treatment not only to separations changes caused by amendments to the Separations Manual, but to all other changes in jurisdictional separations as well.[580] In their view, failure to flow through all changes in separations results will create incentives for carriers to shift costs to the intrastate jurisdiction in ways that do not lead to reductions in interstate revenues. Colorado OCC suggests that carriers can effect such shifts by restructuring traffic patterns[581] or by choosing to assign directly assets that would otherwise be allocated in accordance with relative use.

280. Discussion. We adopt our proposal to require an exogenous cost adjustment for changes in interstate costs which are caused by changes in the Separations Manual. As we stated in the Further Notice, Separations Manual changes are imposed by regulators and are ultimately outside the control of carriers. Furthermore, because Separations Manual changes do not represent changes in the carrier's input costs, but only changes in the allocation of those costs between the carrier's interstate and intrastate activities, such cost changes might not be reflected in the GNP-PI.

281. We see no reason to require AT&T to obtain prior approval for changes which increase the allocation of costs to the intrastate jurisdiction, as suggested by New York DPS. The Separations Manual is amended only after a Federal-State Joint Board has thoroughly studied the likely effects of a proposed change.[582] A change which will result in significant shifts of cost from one jurisdiction to another receives particularly intense scrutiny. This Commission's adoption of such a change in the separations process constitutes all the approval that is necessary for AT&T to reflect that change in its interstate rates.

282. We decline to adopt the proposal of the Colorado OCC to treat as exogenous cost factors all changes in separations results. First, allowing flow through of all separations changes will not eliminate a carrier's

---

579 Networks Comments at 22-23. The Networks' preferred approach would be to place broadcast transmission services in a separate basket. See Section III.C.2.b., above.

580 Colorado OCC Comments at 16.

581 They offer as an example of such restructuring the expansion of local calling areas. Id. at 17.

582 See 47 USC § 410.

incentive to shift costs to the jurisdiction where those costs are most readily recovered. It will merely give them a reason to seek out ways in which to shift costs to the interstate jurisdiction without causing reductions in intrastate revenues.[583] Second, a carrier cannot achieve the kinds of traffic pattern shifts cited by Colorado OCC without a state commission's knowledge. Third, increases in the allocation of costs to one jurisdiction may be due simply to increased demand in that jurisdiction. Such changes certainly should not receive exogenous cost treatment, since they would be accompanied by increases in revenue.

283. Colorado OCC's comments do, however, point to a situation in which we might be required to make an exceptional exogenous cost adjustment because of a change in separations results that is not related to any change in the Separations Manual. It is possible that the allocation of cost to the interstate jurisdiction could increase at a time when interstate demand was static, due to a substantial drop in intrastate demand. In that circumstance, interstate costs could increase with no increase in interstate revenues. In such a circumstance we would entertain a petition to treat some or all of such a cost increase as exogenous, especially if the decrease in intrastate usage was substantial and was brought on by factors beyond the carrier's control.

284. We also decline to adopt the Networks' proposal that we calculate Separations Manual-related exogenous cost adjustments separately for broadcast transmission service. Under our traditional tariff review procedures we have repeatedly investigated the allocation of costs to the television services. In our recent Order concluding our investigation of AT&T's post-divestiture private line services, we found that tariffs currently in effect reflect a reasonable allocation of common costs to those services.[584] As with access charges and with any other exogenous costs that might be said to apply more to one service than to another, we believe that the benefits which might be derived from an attempt to specify in advance the allocation of exogenous costs among the services in a basket would be outweighed by the complexities such requirements would introduce into our formulas. We believe that, at least as long as AT&T maintains its current private line rate structures, the basket and band requirements will protect the Networks from unjustified rate increases.[585] We would, however, give serious consideration

---

583 The incentive to shift costs to the interstate jurisdiction would, of course, be most pronounced in states which have gone even further than we do herein in the direction of eliminating the perverse incentives of rate of return regulation.

584 AT&T Communications, Tariff F.C.C. Nos. 9, 10, and 11, 3 FCC Rcd 4579 at 4588-89 (paras. 66-77)(1988).

585 See id. at 4591 (paras. 84-85). Any restructuring of these offerings

to a petition for investigation of a below-cap rate filing, or to a complaint, if it appeared that cost increases had been applied to one service in a manner so manifestly unfair as to render rates for that service possibly unreasonable.

vi. Depreciation rates and amortization amounts

285. Summary of Further Notice. In the Further Notice we tentatively concluded that cost changes due to changes in depreciation rates were not beyond a carrier's control and should not be treated as exogenous costs. We stated that, although this Commission prescribes depreciation rates, it is the carrier's own decisions concerning the deployment and retirement of assets that are the primary determinant of those rates.[586] We also explained that it has been our policy to establish rates based on a factual inquiry into the actual service lives of equipment, and not based on our view of what those service lives ought to be.[587] We did, however, propose to require downward PCI adjustments to reflect the expiration of the current amortizations of depreciation reserve deficiencies. We reasoned that, because the current higher levels of expense which the amortizations represent are the result of past Commission policies, these expenses are properly regarded as exogenous costs.[588]

286. Pleadings. A number of LECs strongly disagree with the view that depreciation rates are controlled more by the carrier than by regulators.[589] Ameritech, for example, argues that Commission-ordered depreciation rate changes are no less mandatory, and no more affected by endogenous factors,

---

would be subject to full review. See Section III.C.4.f. of this Order.

586 3 FCC Rcd at 3218-19 (paras. 413-15).

587 Id. at 3120 (para. 416).

588 Similarly, we proposed a downward adjustment in LEC PCIs to reflect the expiration of the amortization of capitalized inside wiring expense. Id. at 3221 (paras. 419-20). We do not address this proposal here because it does not apply to AT&T.

589 AT&T did not address this issue during the current round of this proceeding. In response to our original Notice, AT&T stated that depreciation rates should not generally be considered exogenous costs, but that it would like an increase in its current depreciation rates that would trigger a one-time adjustment to its PCIs. See Further Notice, 3 FCC Rcd at 3218-19 (para. 413 & n.856). Depreciation rates for all AT&T study areas will be re-prescribed this year. See Public Notice, DA 88-1547, October 7, 1988.

than the other costs for which we have proposed exogenous treatment.[590] NYNEX characterizes as unfounded our contention that regulators do not control depreciation rate levels, and contends that our proposal "unfairly and disproportionately" impacts shareholder interests by recognizing certain reductions but never increases.[591] SNET states that if a carrier were in control of its depreciation rates, it would be able to use the lives and rates it believed appropriate. According to SNET, its own experience of not being allowed as rapid a rate of depreciation as it would like to use demonstrates that it is not in control and that depreciation rates are, therefore, exogenous costs.

287. The LECs find our proposed treatment of the depreciation reserve deficiency amortizations to be inconsistent with our position regarding depreciation rates in general. NYNEX takes the position that if depreciation rate changes are not exogenous, then the amortizations should not be either.[592] Ameritech points out that we justified our tentative proposal to require price cap adjustments at the end of the amortization period on the grounds that the reserve imbalances which gave rise to the amortizations were the result of regulatory decisions. According to Ameritech, if depreciation reserves are the result of Commission policy, then so are depreciation expenses.[593]

288. GTOC states that it agrees with the implication that carriers should be allowed greater freedom in determination of depreciation rates, but sums up its view of the current situation with the phrase, "the carrier can only propose; the agency disposes."[594] SWB takes the position that carriers certainly influence depreciation rates through deployment decisions, but that rates are also the product of this Commission's regulatory objectives. In SWB's view, exclusion of depreciation rates as exogenous costs must be accompanied by "greater flexibility in a less detailed depreciation rate prescription process."[595] BellSouth states that, if this Commission does feel obliged to continue depreciation rate prescriptions, carriers must be

---

590 Ameritech Comments at 33. Accord CBT Comments at 21; GTOC Comments at 44.

591 NYNEX Comments at 27-28.

592 Id. at 28. Accord CCIA Comments at 11; Ameritech Comments at 35.

593 Ameritech Comments at 34-35.

594 GTOC Comments at 44.

595 SWB Comments at 32.

allowed more flexibility in establishing the lives of assets.[596] Pactel goes even further in this direction, asserting that depreciation expense changes are no different than any other cost changes; they should neither be reviewed by the this Commission nor form the basis for price caps.[597]

289. The Indiana UCC and Maryland PC, on the other hand, both agree with our tentative view that carriers have a high degree of control over depreciation levels. Indiana UCC also argues that not passing on depreciation changes creates an incentive for more efficient investment decisions that is not present when full cost recovery is assured.[598]

290. Discussion. We are not persuaded that we should change our previously-stated position with respect to depreciation rates. It is, of course, true that this Commission prescribes depreciation rates; indeed, we are required by the Communications Act to do so.[599] Pursuant to that statutory mandate, we have established methods and procedures which provide for full recovery of plant investment on a straight-line basis over the life of the plant.[600] Under such a system, the major determinant of the rate of depreciation is the service life of plant. It is the carrier, and not this Commission, that decides when to deploy new plant and when to retire the old. It is, therefore, the carrier, and not this Commission, that primarily controls the rate at which plant investment is translated into depreciation expense.[601] The influence which a carrier exercises over its depreciation

---

596 BellSouth Comments at 60 n.57.

597 Pactel Comments at 60 n.88.

598 Indiana UCC Reply at 22-24; Maryland PC Reply at 16. Colorado OCC, on the other hand, contends that, in recent years, ratepayers have paid higher depreciation payments with the "explicit promise" of lower future rates; according to Colorado OCC, this promised benefit will never materialize under price caps because the higher current costs are built in to rates and costs are thereafter ignored. Colorado OCC Comments at 14-15. It is not clear what explicit promise Colorado OCC is referring to. The only future reduction in depreciation expense levels which could be said to have been "promised" is the relative reduction that will occur at the end of the amortization of the reserve deficiencies, and our proposal retains that reduction.

599 47 USC § 220(b).

600 See generally Property Depreciation, 83 FCC 2d 267 (1980), recon. denied 87 FCC 2d 916 (1981).

601 This is not to say that this Commission's staff never challenges a carrier's initial proposal for represcription of depreciation rates. Depreciation rates are usually prescribed for a future period of several

expense thus differs both in degree and in kind from the influence which the carrier has over truly exogenous cost factors such as changes in the Separations Manual or the Uniform System of Accounts.

291. Even more important than the question of degree of control, however, is the question whether exogenous cost treatment of depreciation rate changes is consistent with the concept of incentive regulation. The idea behind price caps is to provide AT&T with the proper incentives toward efficiency and productivity. Some of the most basic decisions a carrier must make in its quest for improved productivity have to do with the deployment of plant. It must decide when to replace older, maintenance-intensive facilities with expensive but low-maintenance new plant; when to defer new investment; and how to achieve the ideal mix of capital and labor. If we essentially guarantee recovery of one of the types of costs, i.e., depreciation expense, involved in these fundamental decisions, we distort the process and risk destroying the incentives we wish to create. If, on the other hand, we require the carrier to live with the depreciation rates that result from its investment decisions, then we can feel more assured that it is making those long term decisions in ways that will enhance productivity in the long run.

292. Our proposal to require a downward adjustment in the price cap index to reflect the expiration of current reserve imbalance amortizations is not, as the LECs contend, inconsistent with our proposal regarding depreciation rates in general. The need to amortize depreciation reserve deficiencies was created, not by past decisions of this Commission regarding what plant lives should be, but by past methods of calculating depreciation expense. Formerly, we used methods which caused reserve imbalances to develop when carriers accelerated the retirement of plant.[602] Our present methods assure that, on a going-forward basis, this problem will not recur. The amortizations currently in effect are part of the transition from the old to the new methods. They represent depreciation expenses that would have been included in rates over many past years if we had been using our current methods all along. In contrast to the significant role of the carrier in determining its current depreciation expense levels, there is nothing the

---

years. Selection of a rate therefore involves forecasts of the future uses of billions of dollars worth of plant, along with analysis of the possible combined effects of thousands of management decisions that will be made. Even with the basic methodology established, and with agreement on the length of time over which a carrier must be allowed to recover an investment, the process is complex and there is room for disagreement on details. Nevertheless, our methods do not allow us to prescribe rates which are out of keeping with a carrier's capital investment program.

602 See Property Depreciation, 87 FCC 2d 916, 918-19 (1981).

carrier can do now which will have any impact on the progress and expiration of these amortizations. No perverse incentives are created by requiring exogenous cost treatment of these amortizations. On the other hand, it would be unfair to ratepayers who are now bearing the cost of the amortization program if rates were not adjusted downward at the end of the program. We therefore reject the position taken by NYNEX and others that depreciation expense and reserve imbalance amortizations must be treated identically in order to be treated consistently.

293. We also decline to expand this proceeding to include an examination of our current depreciation rate prescription procedures. Since, as explained above, our current processes mirror rather than control the carriers' underlying investment decisions, they are entirely consistent with price cap regulation.

vii. USOA changes

294. In the Further Notice we proposed to treat as exogenous cost factors any changes in carrier costs which are caused by changes in Part 32 of our Rules, the Uniform System of Accounts.[603] All parties commenting on this proposal support it. Several LECs propose that we also include cost changes brought about by changes in generally accepted accounting principles (GAAP).[604] They argue that, although GAAP changes do not always require changes in the USOA, they have the same effect as USOA changes and are equally outside the carrier's control.

295. We confirm our tentative conclusion that cost changes due to changes in the Uniform System of Accounts should be treated as exogenous cost factors. We also agree that there is no difference in principle between a cost change caused by a USOA change and a cost change caused by a GAAP change.[605] We do not, however, authorize carriers automatically to adjust

---

603 47 C.F.R. §§ 32.1 et seq.

604 E.g., GTOC Comments at 45; NYNEX Comments at 30; Pactel Comments at 39-40; USTA Reply at 42.

605 Changes in generally accepted accounting principles are adopted by the Financial Accounting Standards Board (FASB). One could say that GAAP changes affect all entities in the economy and thus are already reflected in the GNP-PI. However, following this line of reasoning would require us by the same logic to prohibit exogenous cost changes for USOA changes that implement GAAP. Furthermore, it is not always clear that GAAP changes, implemented within a regulated system of accounts, have the same impact on carriers as the same changes implemented by industries which do not follow regulated accounting practices. Therefore we conclude that all accounting changes imposed by outside regulatory authority can give rise to exogenous cost adjustments.

price caps to reflect changes in GAAP. Our current procedures for implementing GAAP in the context of the USOA require carriers to notify us of their intention to apply a change in GAAP. They may make the change only if we find it to be compatible with regulatory accounting needs.[606] Some changes in GAAP which are compatible with regulatory needs can be carried out within our existing rules, while others may require amendment of the USOA. A carrier may not adjust its price caps to reflect a change in GAAP until we have approved that change.

viii. Changes in international accounting rates

296. In the Further Notice we requested comment on the complex and difficult policy issues presented by the interaction of international accounting rates with price caps.[607] We noted that, while allowing AT&T to retain as profit any decrease it could negotiate in international accounting rates might provide AT&T with a needed incentive to negotiate lower rates, there were two principal problems with this approach. First, we observed that, to the extent a more favorable rate could be obtained, AT&T would appear to reap a windfall profit solely from a change in regulatory regimes. Second, the assumption that AT&T has sufficient leverage to negotiate more advantageous accounting rates might be mistaken. We tentatively concluded, however, that the public interest would ultimately be served if AT&T were encouraged to negotiate lower international accounting rates, and that changes in international accounting rates should not be treated as exogenous cost factors.

297. No party commented on this proposal. We remain somewhat concerned about windfall profits, and about whether foreign administrations would be willing to consider reductions in accounting rates without the assurance that reduced accounting rates would be translated into reduced IMTS rates and thus into increased demand. Nevertheless, in the absence of record opposition on this issue, we adopt our proposal to encourage AT&T to negotiate lower international accounting rates by treating changes in those rates as endogenous.

ix. Other cost changes

---

606 See Section 32.16 of this Commission's Rules, 47 C.F.R. § 32.16.

607 3 FCC Rcd at 3217 (paras. 410-12).

298. CCIA[608] and SNET[609] argue that all cost changes required by this Commission should be accounted for in the price caps formula as exogenous factors. CCIA cites as an example certain mandated changes in LEC billing practices, which it claims produce costs but no offsetting revenue. Pactel adds that the tax consequences of all regulatory decisions should be included as part of the costs imposed by those decisions.[610]

299. We find that it would be premature to decide now that the effects of all of our future decisions about carrier practices ought to be flowed through to ratepayers as exogenous cost adjustments to price caps. Of course, we will most likely have to include in many future decisions the determination whether the decision requires an adjustment to capped rates. Similarly, the tax consequences of our actions are entirely too speculative for us to determine now that we will always treat them as exogenous factors.

300. Pactel argues that adjustments required under Section 64.901 of our Rules due to failure of a carrier accurately to forecast relative regulated and nonregulated plant usage should be treated as exogenous cost adjustments to price caps. According to Pactel, exogenous cost treatment is necessary to assure that overallocations to regulated activities are corrected and the benefits passed on to consumers.[611]

301. We agree. Under the Joint Cost rules AT&T must allocate common plant investment between regulated and nonregulated activities in accordance with a three-year forecast of relative regulated and nonregulated use.[612] This allocation scheme protects ratepayers from the investment risk associated with AT&T's nonregulated businesses by excluding from AT&T's rate base both plant investment currently used for nonregulated purposes and spare capacity intended for future nonregulated use. In order to safeguard against manipulative or unintentional underforecasts of nonregulated use, we require AT&T to make a new three-year forecast each year and to allocate additional amounts to nonregulated activities each time a new forecast shows that previous forecasts have underestimated nonregulated use of plant.

302. Under rate of return regulation, these required reallocations translate into reductions in rate base and in regulated cost, which in turn

---

608 CCIA Comments at 11.

609 SNET Comments at 33.

610 Pactel Comments at 38.

611 Id. at 38, 39 n.55.

612 47 CFR § 64.901

produce reductions in regulated rates. Under our price cap proposal, however, reallocation of regulated investment to nonregulated activities would have no impact on interstate rates. The investment risk associated with plant in place on the first day of price cap regulation would continue to be borne by ratepayers and shareholders in accordance with the forecast in effect on that day, even if AT&T were later to dramatically increase its nonregulated use of that plant. Thus, in order not to undermine the intent of the Joint Cost rules,[613] we must require an exogenous cost adjustment to be made whenever regulated investment is reallocated to nonregulated activities.

303. Pactel contends that uncontrollable "extraordinary costs," such as the costs which would result from a major earthquake, should be treated as exogenous cost factors.[614] We disagree. We realize that it is possible that an unforeseen catastrophe could cause AT&T to need to raise rates above the cap, and that the required showing for above-cap rates might not be appropriate to such a circumstance. On the other hand, a carrier's ability to cope with unforeseen events, yet remain competitive, is in part a function of its engineering, investment, and operational decisions. We would create the wrong incentives if we were to promise automatic flow-through of all extraordinary costs. We would also set the stage for an endless succession of arguments focused on whether a particular cost really qualifies as "extraordinary." We therefore decline to treat all allegedly extraordinary costs as exogenous cost factors. Consistent with the Constitutional ban on confiscatory rates, however, we leave open the possibility that, in a truly extraordinary situation, we would waive part of the extensive showing required to justify above-cap rates.

304. The Michigan PSC argues that AT&T should be required to pass through savings it achieves through bypass. Otherwise, they claim, consumers will have to pay both excessively high AT&T rates and LEC rates which include stranded investment.[615] Bell Atlantic agrees. According to Bell Atlantic, passing through reduced access costs while allowing AT&T to retain savings due

---

613 In the long run, incentive regulation should reduce the incentive for AT&T to shift costs from nonregulated to regulated activities. However, we continue to believe, as we stated in the Further Notice, that continuation of the Joint Cost scheme is necessary in order to maintain the integrity of the jurisdictional separations process. Furthermore, in the short term, it will be necessary in the performance review of the initial price cap period to be able to determine accurately how much of the investment on AT&T's books is properly attributable to nonregulated activities.

614 Pactel Comments at 39.

615 Michigan PSC Comments at 15.

to bypass creates incentives towards uneconomic bypass.[616] We disagree. Indeed, if we were to remove the incentives that AT&T has to minimize its access costs, we would also thereby remove any incentives which LECs might have to reduce access costs to levels which would discourage uneconomic bypass.

e. Operation of the Price Cap Index

i. Frequency of Adjustments

(1) Summary of Further Notice

305. In the Further Notice this Commission tentatively concluded that with the exception of access cost reductions due to Commission-mandated subscriber line charge (SLC) increases, which we proposed to flow through to the PCI immediately, AT&T's price caps should be adjusted on an annual basis.[617] We explained that annual adjustments would ensure that below-cap rates reflected changing costs and, thus, that it would be reasonable to afford such rates streamlined tariff review treatment.[618] We also tentatively determined that annual updating of the PCI would avoid the potential rate churn that might result from more frequent adjustments.[619]

(2) Pleadings

306. Only a few parties commented on our proposal regarding the timing of price cap adjustments. NYNEX and Pactel support the concept of annual PCI adjustments, although the latter urges this Commission to clarify that known and quantifiable exogenous cost changes that will occur during an upcoming price cap tariff year should be included in the adjustment at the time of that filing.[620] On the other hand, AT&T contends that this

---

616 Bell Atlantic Comments at 11-13. See also US West Reply at 28-36. We address US West's proposals in the context of our discussion regarding the PCI formula. See Section III.C.1.e.ii, infra.

617 Further Notice, 3 FCC Rcd at 3427 (paras. 427-428). With regard to SLCs, we noted that, as a practical matter, since the current SLC implementation schedule requires SLC increases to become effective on or before the April 1, 1989, price cap initiation date, no mid-year PCI adjustment would be necessary and no rate churn would result. Id. at 3427 (para. 428).

618 Id. at 3427 (paras. 427-28).

619 Id.

620 NYNEX Comments at 4; Pactel Comments at 40.

Commission should provide a procedure for expedited adjustment of its price caps and bands in response to mid-year exogenous cost changes, including changes in access costs. In this regard, AT&T asserts that in order to permit AT&T to reflect changed access costs as soon as they occur, its notice period for PCI adjustments must be shorter than the periods applicable to the LEC tariff revisions giving rise to the changes.[621] ACTA and PRTC contend that while most adjustments to AT&T's caps should be made annually, adjustments reflecting access costs should be made quarterly.[622] They claim that in the absence of more frequent access cost adjustments, AT&T could utilize the pricing flexibility resulting from unreflected access cost decreases to finance predatory behavior.[623]

(3) Discussion

307. We find no reason to alter our earlier tentative assessment that AT&T must file adjustments to its price cap indexes each year in connection with its annual price cap tariff filing. However, we find merit in the contentions of those parties who claim that if AT&T's PCIs are only adjusted once per year, they may not adequately reflect current costs. From the consumer's perspective, this concern is accentuated in the current era of generally falling access costs. As a result, we conclude that AT&T must update its PCIs to account for mid-year exogenous cost changes.[624] We expect that AT&T's rates, as reflected in its Actual Price Indexes (APIs), will remain less than or equal to its updated PCIs at all times.[625]

ii. Adjustment Mechanism

(1) Summary of Further Notice

---

621 AT&T Comments at 40 n.***.

622 ACTA Comments at 11-14; PRTC Comments at 23-25; PRTC Reply at 3.

623 Id.

624 In light of this conclusion, we reject Pactel's contention that known and quantifiable future exogenous cost changes should be reflected in the PCI at the time of the annual price cap tariff filing. We believe that the PCI would more accurately reflect current costs if future exogenous cost changes are included in PCI updates at the time the cost changes become effective.

625 See new §§ 61.49(e) and 61.58(c)(3) of this Commission's Rules in Appendix B, infra.

308. In the Further Notice, we proposed to "cap" rates on defined groups, or "baskets," of AT&T's services by requiring that an index of AT&T's actual prices for services in each basket (the actual price index, or API) not exceed an index of the basket's costs (the price cap index, or PCI).[626] We proposed that both the API and the PCI be Laspeyres indexes in the sense that they reflect the movement in a basket's aggregate rates and costs, weighted according to their relative importance in a base period.[627] We tentatively determined that the Laspeyres indexing methodologies we proposed to employ were preferable to Paasche indexes, which use current period rather than base period weights, since Paasche indexes require demand projections that would add potentially costly and controversial preliminaries to the index calculations.[628]

309. We proposed to require annual adjustments to each basket's PCI pursuant to the following formula:

$$PCI(new) = PCI(base)[1.0 + w(I - X)/100 + \Delta Y/R + \Delta Z/R]$$

where I = the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

w = base period gross revenues, minus base period access costs and net of ΔZ, all divided by base period gross revenues (which, together, equals the proportion of base period non-access costs that will recur in the upcoming tariff year),

ΔY = the dollar magnitude of any change in access charges for the upcoming tariff year, evaluated at base period demand,

---

626 Further Notice, 3 FCC Rcd at 3434 (para. 443).

627 Id. at 3435 (para. 444).

628 Id. at 3435 (para. 445).

ΔZ = the dollar magnitude of any other exogenous cost changes, evaluated at base period levels of operations, and

R = base period gross revenues (to act as a surrogate for the basket's total base period costs).

(2) Pleadings

310. A number of parties express concerns that, by providing that access costs and other exogenous cost changes be flowed through to aggregate baskets, our proposed price cap plan does not ensure that such cost changes are reflected in the rates of the affected services. These issues are addressed in Section III.C.2.d, infra, regarding the design of the plan's baskets and bands. However, several commenters raise issues directly related to the mechanics of the PCI adjustment formula we proposed in the Further Notice.

311. AT&T contends that the proposed PCI formula fails to reflect changes in exogenous costs accurately, because different components of that formula incorporate exogenous cost changes from different (and overlapping) periods.[629] In particular, AT&T argues that the "PCI(base)" variable reflects the cap level for the immediately preceding tariff year, while the exogenous cost variables ($\Delta Y/R + \Delta Z/R$) measure exogenous cost changes against the base period (the 12-month period beginning 18 months prior to the new tariff year).[630] AT&T asserts that the result of these purportedly overlapping variables is that the "$\Delta Y/R + \Delta Z/R$" components measure not only the anticipated cost changes in the upcoming tariff year, but they also partially account for prior cost changes that have already been reflected in the "PCI(base)" variable.[631] According to AT&T, the consequence of this purported formula design error is both to exaggerate trends in exogenous cost changes and to understate fluctuations in exogenous costs.[632] AT&T runs several hypothetical access cost changes through the formula in an attempt to demonstrate that the formula does in fact exhibit anomolous behavior.[633]

---

629 AT&T Comments, App. C at 1.

630 Id., App. C at 1-2.

631 Id.

632 Id., App. C at 1.

633 Id., App. C at 2-5.

312. AT&T's proposed solution to the alleged formula anomalies is to calculate the PCI using current prices and costs at base period quantities instead of using actual base period revenues and costs. AT&T would therefore change the definitions of the "R" and "ΔY" variables in the formula as follows:

> R = base period demand for each rate element "i," multiplied by the current price for each such rate element "i."
>
> ΔY = (new access price) x (base period demand), minus (old access price) x (base period demand).[634]

313. NYNEX and United generally agree with AT&T's analysis of the alleged problems with the PCI formula proposed in the Further Notice, noting that the problems arise by virtue of the six-month lag between the start of each tariff year and the end of each base period.[635] However, both LECs propose solutions to this alleged problem that differ from the AT&T proposal. The NYNEX solution is not explained in detail, but it appears to involve annual after-the-fact corrections to the "ΔZ" and "ΔY" variables. According to NYNEX, its corrections solve the tendency of the formula to overstate trends in exogenous costs.[636] United urges this Commission to adopt the PCI formula proposed by USTA.[637]

314. US West raises a different concern regarding the application of the proposed PCI formula to AT&T. According to US West, by limiting the PCI's "Y" variable to the cost of access purchased from LECs, rather than including AT&T's total access costs (from whatever source), we create incentives for AT&T to engage in uneconomic bypass of LEC access facilities.[638] US West

---

634 Id., App. C at 12.

635 NYNEX Reply, App. C at 1; United Reply at 10. Cf. NTN Reply at 28-29 (acknowledging, without taking a position on, the methodological issues raised by AT&T, and noting that AT&T's complaints suggest that this Commission may not have carefully considered the proposed plan).

636 NYNEX Reply, App. C at 3-6.

637 United Reply at 10. We note that USTA proposed a PCI formula in Attachment A of its reply comments, dated December 4, 1987, in response to the original Notice. However, that plan does not appear to present a precise and detailed approach regarding the very matter at issue here -- the baseline costs against which current cost changes are compared.

638 US West Reply at 28-36. See also Section III.C.1.d, supra, addressing

explains that in times of falling access costs, AT&T can reduce the size of the negative "ΔY/R" ratio, and thus lessen the downward pressure on the PCI, by purchasing access from non-LEC sources.[639] US West contends that bypassing LEC access facilities will also result in a larger "w" variable -- defined as (R - Y + ΔZ)/R -- which may increase the PCI.[640] US West adds that in times of rising access costs, the formula will have the opposite effect of discouraging economic bypass.[641] As a result, US West urges this Commission to modify the PCI formula either to include bypass-related costs within the definition of "Y",[642] or to include an additional "projected LEC access chang[e]" variable in the formula.[643]

(3) Discussion

315. We conclude that the basic structure of the PCI proposed in the Further Notice is sound, and, with modifications discussed below, should be adopted. That basic structure includes use of base period weighting, the direct flow-through of changes in LEC-provided access costs and costs due to specified regulatory changes, and the use of the GNP-PI and a productivity offset as predictors of "direct expenses" over which AT&T can exert managerial control. We continue to believe that a price cap index that recognizes changing costs in this manner will give us reasonable assurance that below-cap rates fall within the zone of reasonableness from both the carrier's and the ratepayer's perspective.[644]

316. As noted above, however, we believe that the proposed PCI formula does require some modification to function properly. In particular, we find merit in the assertions of AT&T, NYNEX, and United that the PCI formula proposed in the Further Notice does not reflect mid-base period exogenous cost changes accurately. Moreover, the formula will not accommodate our decision here to require mid-year updating of the PCI to reflect exogenous

---

generally the issue of whether bypass costs should be included as exogenous cost adjustments to the PCI.

639 Id. at 34.

640 Id.

641 Id. at 35.

642 Id. at 36-37.

643 Id. at 37.

644 See Further Notice, 3 FCC Rcd at 3384 (para. 336). See also Section V, infra, regarding this Commission's legal authority to adopt price caps.

cost changes. The concept behind the PCI design proposed in the Further Notice was to use base period historical data to establish the weight given current cost categories, thus obviating the need for demand projections. The proposed formula's shortcomings appear to result, as AT&T suggests, from its unintended trait of measuring cost changes by comparing costs in base periods and tariff years that overlap.

317. We believe these problems relating to the proposed PCI formula can easily be addressed through modifications similar to those suggested, albeit in incomplete form, by AT&T. In particular, we conclude that the formula should be amended to measure cost changes over contiguous time periods, while using base period data only to establish the weights assigned to those cost changes.[645] Thus, as modified, the PCI formula we are adopting provides for price cap adjustments as follows:

$$PCI_t = PCI_{t-1}[1 + w(GNP\text{-}PI - X) + \Delta Y/R + \Delta Z/R]$$

where

GNP-PI = the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

ΔY = (new access rate - access rate at the time the PCI was updated to PCI_{t-1}) x (base period demand),

ΔZ = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

---

645 We propose to retain the same base period proposed in the Further Notice -- the 12-month period ending six months prior to the effective date of AT&T's annual price cap tariff filing. However, the role served by the base period differs under the new formula. The formula in the Further Notice used actual base period access and exogenous costs both to establish the relative weights of the formula's cost categories and to provide the baseline levels against which cost changes are compared. The new formula utilizes base period demand quantities to establish weights, but compares current with immediately preceding costs.

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI to updated to PCI_{t-1},

w = R - (access rates in effect at the time the PCI was updated to PCI_{t-1} x base period demand) + ΔZ, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

Under this modified formula, each adjustment to the PCI would reflect the incremental change in the index caused by the most recent cost changes, rather than reflecting a comparison of current versus base period costs. This method of measurement eliminates the problem identified by commenters of comparing inconsistent time periods within the formula.

318. In most other respects, the PCI formula we are adopting differs little from the formula proposed in the Further Notice. Consistent with our proposal in the Further Notice, the "(GNP-PI - X)" variable will have the same value for each basket of AT&T's services in any given year,[646] and, as a predictor of annualized changes in non-access costs, will be factored into each index only at the time of the annual price cap filing, regardless of how many times the PCI is adjusted for changes in exogenous costs during the year. Unlike the "(GNP-PI - X)" component, the "ΔY" and "ΔZ" variables in the formula will vary by basket, depending upon the impact of regulatory changes and changes in access charges on the cost of providing the particular services in each basket.[647]

319. In light of the important role we assign to basket definition in protecting consumers of MTS and other services over which AT&T retains significant market power, it is essential that AT&T properly allocate exogenous cost changes, including changes in access costs, among baskets. With respect to non-traffic sensitive access costs, AT&T must first calculate the net change in such costs, at base period demand, associated with all of its capped services.[648] AT&T must then allocate this amount among its baskets

---

646 Further Notice, 3 FCC Rcd at 3385 (para. 337).

647 See Section III.C.1.d, supra, and Section III.C.2.b, infra.

648 This calculation would net out potentially offsetting non-traffic sensitive access cost increases and decreases, such as those associated with changes in terminating CCL charges, originating CCL charges, and charges for the Universal Service Fund and Lifeline programs.

according to the proportion of total base period non-traffic sensitive minutes of access (both originating and terminating) associated with each basket. Similarly, AT&T must allocate the change in its total traffic sensitive access costs (calculated at base period demand) among baskets in proportion to their share of total base period traffic sensitive minutes. We require that changes in special access costs (calculated at base period demand) be assigned directly to the baskets in which those costs are incurred. With respect to exogenous cost changes reflected in the PCI's "ΔZ" variable, we require that such changes be allocated on a cost causative basis.[649]

320. In Section III.C.1.d, supra, we rejected the proposal that AT&T's price cap levels should be adjusted to reflect cost savings due to bypass. We here reject US West's specific contention that our PCI formula should require the direct flow-through of non-LEC access cost changes, and that its failure to do so creates a genuine risk that AT&T will engage in uneconomic bypass of LEC access facilities.[650] First, since non-LEC access costs are not reflected in tariffs on file with this Commission, our ability to monitor the direct flow-through of such costs into the PCI would be administratively burdensome. In addition, non-LEC access costs are unlikely to be entirely exogenous to AT&T, since, unlike LEC-provided access, such costs are beyond our control. As a result, direct flow-through of such costs would undercut the efficiency incentives we wish to encourage through price cap regulation.

321. Moreover, it appears unlikely to us that AT&T could, in fact, "game" the PCI successfully through uneconomic bypass of LEC facilities. Under price caps, AT&T's incentive at any time is always to keep costs as low as possible. Therefore, it has no incentive to engage in uneconomic bypass, unless by doing so it can raise the PCI in the future, allowing it to raise its prices enough to recoup the current losses from using the higher-priced non-LEC access. Since the "Y" variable in the proposed PCI formula reflects access costs at base period weights, AT&T would be substituting for its LEC-provided access, non-LEC access of equal or greater cost for an entire base period before the effects of such uneconomic bypass would be reflected in the PCI. In order to make such a course of action profitable, AT&T would need to be able to predict accurately the future time path of LEC access charges, the future time path of non-LEC access costs, and the future time

---

649 Allocations between price cap services, as a group, and non-price cap services, as a group, must also be made on a cost-causative basis to ensure that the aggregate cost levels of all price cap services are accurately reflected in the PCIs.

650 The reasoning outlined below applies equally to rebutting US West's contention that the proposed PCI formula could, in times of rising access costs, discourage economic bypass.

path of inflation.[651] In addition, of course, market conditions would need to be such that AT&T could actually increase revenues by raising its prices to meet the elevated PCI; to the extent that competition or other factors keep the API below the PCI, any uneconomic bypass strategy would be irrational.

2. Application of the PCI to AT&T Services

a. Existing services: Inclusions and Exclusions

i. Summary of Further Notice

322. In the Further Notice, we proposed to cap all existing services of AT&T, with the exception of services now subject to separate accounting requirements, Tariff 5 special construction services, and Tariff 12 custom-designed services.[652] We said that we had subjected certain services to separate accounting requirements in part to eliminate AT&T's opportunity to subsidize these services improperly from other regulated service revenues, and that we therefore would exclude these services from price cap regulation.[653] In addition, we tentatively concluded that Tariff 12 services are long term, individualized offerings for which capping appears unnecessary or possibly counterproductive. We tentatively decided a better course would be to apply conventional tariff review scrutiny to Tariff 12 services.[654] Finally, we tentatively concluded that special construction tariffs, which typically involve either long term offerings or a one-time non-recurring charge, are not good candidates for price cap regulation since the charges are particularized by circumstance and customer.[655] We proposed to continue to require separate accounting and reporting for those services now subject to such requirements, and to apply conventional 45-day tariff notice and existing tariff review standards to those services held outside of price cap regulation. In addition, we proposed that we would not include revenues and losses derived from Tariff 12 and special construction services in AT&T's price cap

---

651 Inflation is relevant in two respects. First, it has a bearing on the cost of current losses that must later be recouped through the added pricing flexibility afforded by a higher PCI. Second, to the extent that the annual increase in the GNP-PI is less than the formula's 3 percent productivity offset, an increase in the "w" variable resulting from decreased LEC-provided access costs will actually lower the PCI.

652 Further Notice, 3 FCC Rcd at 3316 (para. 222).

653 Id.

654 Id. at 3317-18 (para. 224).

655 Id. at 3319 (para. 227).

performance review, thereby ensuring that shareholders and not ratepayers bear the risk for such services.[656]

ii. Pleadings

323. Those parties commenting on the proposed exclusions for AT&T generally support this Commission's proposed approach. EDS and the Executive Agencies support the exclusion of services subject to separate accounting, Tariff 12 services, and special construction services.[657] The Executive Agencies argue that such exclusions would deprive AT&T of the opportunity to cross-subsidize these highly competitive services with revenues from other, less competitive services.[658] API and Wisconsin PSC support the exclusion of Tariff 12 services, as well as other services AT&T offers on a customer-specific basis.[659] EDS and Comptel contend that the investigations of Tariff 12 and other customer-specific tariffs must be resolved promptly.[660] Wisconsin PSC stresses that the actual price index must not include the prices charged under Tariff 12 arrangements, and that neither prices nor revenues attributable to these services should be included in weighted averages used in the price cap formulas.[661]

324. The Executive Agencies propose that this Commission forbear from regulating services that are excluded from the price cap. The Executive Agencies explain that they acquire telecommunications services on a competitive bid basis insofar as possible, and that vendors must be able to translate the terms of their offers into binding contracts. The Executive Agencies contend that the net revenue test is a reasonable basis for evaluating services submitted in response to competitive procurements. If a competitive service fails the net revenue test, the Executive Agencies propose that the costs and revenues of the service be isolated to ensure that shareholders, rather than customers, absorb the loss. The Executive Agencies conclude that their proposal eliminates the possibility of cross-subsidization and predation.[662]

---

656 Id. at 3316-17 (para. 222).

657 EDS Comments at 16-17; Executive Agencies Comments at 20-21.

658 Executive Agencies Comments at 21.

659 API Comments at 28; Wisconsin PSC Comments at 5.

660 EDS Comments at 16-17; Comptel Comments at 7.

661 Wisconsin PSC Comments at 5.

662 Executive Agencies Comments at 20-26.

325. Michigan PSC argues that the exclusion of certain services from the cap raises the possibility that AT&T would be able to move an existing capped service into an exempt service category, and reprice that service. In addition, Michigan PSC contends that revenues from special construction must be held separate from capped revenues and continue under rate of return reporting requirements. Michigan PSC also proposes that this Commission develop a separate procedure for allocating costs to excluded categories so that excessive joint and common costs are not added to special construction revenue requirements. Finally, Michigan PSC argues that although price caps should not affect existing contract-type services, at the expiration of the contracts, the price cap plan should provide a way to bring contract-type services under the cap.[663]

326. In addition to the exclusions proposed in the Further Notice, parties have proposed the exclusion of international services, 800 Service, and Tariff 11 services. ICA argues that this Commission should defer the application of price cap regulation to international services until facilities-based competition has matured.[664] PRTC contends that 800 Service should not be capped until the 800 database is complete.[665] AT&T and the Networks argue for the exclusion of AT&T's Tariff 11 Local Channel Service, pursuant to which AT&T offers LEC special access to its private line customers. AT&T argues that the majority of the cost to customers of Tariff 11 reflects the flow-through of LEC special access charges. AT&T states that it has no practical control over the price of Tariff 11 service because its customers can purchase special access directly from the LECs or through third parties. Therefore, AT&T concludes, the inclusion of Tariff 11 is unnecessary, and, because of its 55,000 rate elements, complicated. AT&T proposes that Tariff 11 be excluded from the cap and receive streamlined tariff review.[666] The Networks support the exclusion of Tariff 11, and suggest that AT&T be required to flow through LEC rate changes, subject to streamlined regulation and a rule that access charges be flowed through on a service-by-service basis. The Networks propose that any changes to AT&T's Tariff 11 formula be subject to full regulatory scrutiny and 90 days' notice.[667]

---

663 Michigan PSC Comments at 18-19.

664 ICA Comments at 22-23.

665 PRTC Reply at 21 n.20 (citing Provision of Access for 800 Service, CC Docket No. 86-10, Supplemental Notice of Proposed Rulemaking, 3 FCC Rcd 721 (1988)).

666 AT&T Comments at 9 n.**.

667 Networks Reply at 23-24.

iii. Discussion

327. Although we believe that capping all existing AT&T services would yield the greatest benefits, some services are structured and priced in such a way that applying a price cap structure to them would be excessively difficult. For example, prices of services that consist of long term contracts would not be driven down by the operation of the formula, and the inclusion of these services in the cap might give AT&T a means of raising the prices of other services. Futhermore, no party has come forward with an alternative means of capping these special services. We will therefore exclude them from the cap. The question whether such services should be deregulated is not part of this docketed proceeding, however, and we require that they remain subject to conventional tariff review.

328. Services subject to separate accounting requirements, special construction services, Tariff 11 services, and Tariff 12, Tariff 15, and Tariff 16 services[668] shall be excluded from price cap regulation. We will

---

668 These excepted services include Accunet Packet Switching, Skynet KU, Non-IMTS, Tariff 5 services, Tariff 11 services, Tariff 12 services, including Special Routing Arrangement Service, Defense Commercial Telecommunications Network (DCTN), Digital Tandem Switched Network and Arrangements (DTSN), and Virtual Telecommunications Network Service (VTNS), Tariff 15 services, including Holiday Rate Plan, and Tariff 16 services including Oahu Telephone Communications Service (OTCS) and FTS 2000. See, e.g., AT&T Communications, Transmittal No. 474, Mimeo No. 3264 (Mar. 25, 1986); AT&T Communications, Transmittal No. 581, Mimeo No. 4620 (May 20, 1986), review denied, 2 FCC Rcd 444 (1987); AT&T Accounting and Cost Allocation Plan, CC Docket No. 85-107, Mimeo No. 7222 (Oct. 2, 1986); AT&T Communications, Transmittal No. 425, Mimeo No. 3502 (Apr. 3, 1986); AT&T Communications, Transmittal Nos. 895 and 961, CC Docket No. 87-568, 2 FCC Rcd 5493 (1987) (August 19 Order), issues designated, AT&T Communications, Transmittal Nos. 895 and 961, 2 FCC Rcd 7389 (1987) (December 14 Order); AT&T Communications, Transmittal Nos. 1018 and 1102, 3 FCC Rcd 995 (1988) (February 9 Order); AT&T Communications, Transmittal No. 1145, 3 FCC Rcd 2837 (1988) (April 28 Order); AT&T Communications Transmittal Nos. 1336 and 1349, DA 88-1714, released Oct. 28, 1988; AT&T Communications Transmittal No. 1409, DA 89-76, released Jan. 27, 1989; AT&T Communications, Transmittal No. 1215, CC Docket No. 88-471, FCC 88-299, released Sept. 20, 1988 (Tariff 15 Order); AT&T Communications, Transmittal No. 1445; AT&T Communications, Transmittal No. 1493, DA 89-245, released Feb. 16, 1989. We do not mean to include within the exception services subject to accounting orders merely as part of an ongoing tariff investigation. Rather, we intend to include within the exception those services subject to below-the-line accounting treatment.

continue to require separate accounting and reporting for those services now subject to such requirements, and we will apply conventional 45-day tariff notice and existing tariff review standards, except for non-IMTS, which will continue to receive streamlined treatment. In addition, revenues and losses derived from all excluded services will be reported separately from capped services for the purposes of AT&T's performance review.

329. Special construction tariffs typically involve either long term offerings, or a one-time, non-recurring charge. In either case, a cap appears superfluous. As Michigan PSC suggests, we will require AT&T to keep revenues from special construction and other exempt services separate from capped revenues. Costs and revenues associated with exempt services will be reported by AT&T in its annual ARMIS filing.[669] Michigan PSC also has argued that at the expiration of existing contracts, all future contract-type services should be brought under the cap. We disagree. The rationale for excluding special construction services derives from the nature of the service, not from the expectations of customers. Capping a long term offering that already contains a guarantee of price stability, could permit the carrier to employ unused, permissible increases for such services to increase the rates for other services. Capping a non-recurring charge in the context of a special construction tariff appears irrelevant.

330. For similar reasons, we have decided to hold Tariff 12, Tariff 15, and Tariff 16 services out of the cap.[670] In addition, in their present configurations Tariff 12 and Tariff 15 services raise cross-subsidization, discrimination, and other concerns, that do not lend themselves to the streamlined treatment price caps provide. We believe that holding these services out of the cap, and applying conventional as opposed to streamlined tariff review scrutiny to them, will better protect consumers. We will consider future custom tariffs on a case-by-case basis.[671] We agree with

---

669 See discussion of monitoring and reporting, Section III.E, infra.

670 At the time of the Further Notice, the only custom tariffs filed by AT&T were in Tariff 12. Subsequently, however, AT&T has filed two other custom tariffs, Tariff 15 and Tariff 16. For purposes of defining the boundaries of price caps, we believe the issues raised by Tariff 15 are identical to those considered with respect to Tariff 12. In all three cases, the services represent long term, customized treatment. In addition, these tariffs raise varying concerns for which conventional, rather than streamlined, review is suitable. See Further Notice, 3 FCC Rcd at 3318 (para. 225); Tariff 15 Order at para. 44.

671 Thus, new services offered under Tariffs 12, 15, and 16 are not eligible for review under the net revenue standard and will not be eligible for inclusion in price caps. Of course, should major structural changes be made to existing contract-type tariffs, as a result of our investigations or for

those parties that urge that the investigations of Tariff 12 and Tariff 15 be resolved as promptly as possible; we are proceeding expeditiously with those investigations. In addition, we reiterate, in response to Wisconsin PSC, that the actual price index will not include prices charged under Tariff 12 arrangements, and that neither prices nor revenues attributable to those services will be included in weighted averages used in price cap formulas.

331. We do not, however, adopt the separate allocations procedure for excluded services that Michigan PSC proposes. The adoption of price cap regulation does not require that this Commission change the manner in which it regulates services not subject to caps. Currently we do not prescribe cost allocation procedures for individual services. Rather, when AT&T fixes rates for a service, the burden is on AT&T to demonstrate a reasonable allocation of costs to that service. Since the excluded services are to be subject to conventional tariff review, AT&T will continue to bear that burden. We will, of course, expect AT&T to use consistent cost allocation methodologies over time and across services. While we do not share Michigan PSC's concern about allocation of excess joint and common costs to special construction services, we are concerned about the related possibility that, at the time of the performance review, AT&T might be tempted to manipulate the allocation of cost between price cap and non-price cap categories. It is for the purpose of limiting AT&T's ability to shift costs in this fashion that we are requiring regular reporting of cost allocations through ARMIS.[672]

332. Michigan PSC's concern that AT&T will be able to move capped services out of the cap into the excluded service category and reprice them does not appear to be well-grounded. We have delineated the types of services that are excluded, and these services are subject to conventional tariff review. It is unlikely that AT&T could take any action of the sort suggested by Michigan PSC without the awareness of this Commission and other interested parties.

333. The Executive Agencies propose that this Commission forbear from regulating services that are excluded from the price cap.[673] As we stated in the Further Notice, such an undertaking is beyond the scope of this rulemaking, and would entail intricate factual and definitional judgments

---

any other reason, we may at a future time renew consideration of whether the tariffs ought to be included in price cap regulation. New contract-type tariffs, other than those filed under the auspices of Tariffs 12, 15, and 16, will be considered for inclusion under price caps on a case-by-case basis.

672 See generally Form 901 Order.

673 Executive Agencies Comments at 20-26.

better suited to a separate proceeding.[674] Undertaking such a proceeding simultaneously with the implementation of price cap regulation would unduly complicate the transition to this new method of regulation.

334. Finally, parties propose that certain additional services be excluded from the cap. ICA argues that this Commission should not apply price cap regulation to international services until facilities-based competition has matured,[675] and PRTC suggests that 800 Service should not be subject to price cap regulation until the 800 database is complete.[676] Concerns about vestiges of monopoly in international MTS and 800 Service can be, and we believe are, addressed by the baskets and bands approach we have selected for AT&T.[677] Futhermore, unlike services involving long term contracts or special construction services, these services are ideally suited for incentive regulation.

335. AT&T and the Networks argue for the exclusion of Tariff 11. Tariff 11 essentially represents a pass-through of charges AT&T incurs to obtain special access circuit components under LEC special access tariffs.[678] AT&T applies a rate adjustment factor (RAF) of 10.1 percent to charges for local channel services in order to derive its Tariff 11 rates.[679] In addition to the rate elements representing flow-through of LEC special access, Tariff 11 contains a few rate elements, such as the access coordination function, that are related only to AT&T costs.[680]

---

674 Further Notice, 3 FCC Rcd at 3320 (para. 126).

675 ICA Comments at 22-23.

676 PRTC Reply at 21 n.20.

677 See Section III.C.2.b, infra.

678 See AT&T Communications, Tariff F.C.C. Nos. 9, 10, and 11, Transmittal Nos. 285, 318, 342, 346, 504, and 559, CC Docket No. 85-400, 3 FCC Rcd 4579 (1988) at para. 1.

679 Id. at para. 80.

680 AT&T Tariff F.C.C. No. 11, pages 67.4, 74, 74.16.2, 75.14, 85.23, 85.48, 86.12 (access coordination function); page 86.2.8 (review of communications system test results and special participative design review, technical analysis, and testing); page 86.2.9 (customer directed participative testing); page 86.2.12 (provision of a design layout report); pages 86.1.7-86.1.9 (automatic voice correcting arrangements); page 86.1.9 (data access arrangements); page 86.1.10 (drainage coils and isolation transformers and transformers for audio tone protective relaying channel); page 86.2.4.5.9 (synchronization arrangement). See Letter from G. Morlan, AT&T to Legal

336. We conclude that, because of its status as a flow-through tariff, Tariff 11 should be excluded from the cap. Tariff 11 by and large represents the flow-through to AT&T customers of LEC special access prices, over which AT&T has virtually no control. Price cap regulation is designed to give AT&T incentives to lower its costs by being efficient and innovative. As the vast bulk of the costs of providing Tariff 11 service are LEC special access rates, AT&T has minimal ability to act on the incentives to lower costs provided by price caps. For these reasons, price cap regulation appears unsuited to Tariff 11. Furthermore, we conclude that exclusion from the cap is unlikely to injure Tariff 11 customers in any way, because of the existing market check on Tariff 11 rates. AT&T's ability to alter Tariff 11 rates is severely limited by the fact that customers are free to purchase special access services directly from the LECs. Those elements of Tariff 11 that are under the sole control of AT&T, including the rate structure, the RAF, and the non-LEC-related rate elements, have remained unchanged for some time. The current rate structure for Tariff 11 has been in effect since 1985, and the current RAF since 1986.[681] Tariff 11 rates have been relatively stable, and we have no reason to expect that they will change before the initial AT&T performance review. Indeed, any changes in the rate structure, the RAF, or the non-LEC-related rate elements would be a cause for our concern. Of course, such changes would be subject to conventional tariff review. The RAF and non-LEC-related rate elements are under the sole control of AT&T, and are to be distinguished from tariff filings that simply flow through changes in LEC special access charges. In the past, we have permitted AT&T to flow through LEC special access changes on very short notice,[682] and we would not expect the extent of review to be greater in the future for rate changes reflecting changes in LEC special access prices.

b. Baskets and Bands

i. Summary of Further Notice

337. In the Further Notice, we tentatively concluded that a combination of baskets and bands would provide us with the regulatory control required to ensure that consumers receive the benefits we expect to flow from price

---

Assistant to Chief, Common Carrier Bureau, Oct. 21, 1988.

681 Transmittal Nos. 504 and 559, AT&T Communications Tariff F.C.C. Nos. 9, 10, 11, CC Docket No. 85-400, Memorandum Opinion and Order, 1 FCC Rcd 1016 (1986).

682 See, e.g., Letter from Chief, Tariff Division, to W.E. Lind, AT&T, Special Permission No. 87-196, Application No. 445 (Mar. 16, 1988), granted March 18, 1988 (giving AT&T special permission to file on one day's notice).

caps, and that rates stay within the zone of reasonableness.[683] We tentatively concluded that a baskets and bands approach would foster growth of competition, and give AT&T the freedom to manage its business in the most efficient and innovative fashion consistent with the maintenance of just and reasonable rates.[684] We stated that imposing an aggregate cap on a basket of services assures regulatory control over prices charged to the class of consumers of services within the basket, and prevents cross-subsidization of services outside the basket by those inside.[685] For AT&T, we proposed two baskets: one for private line services, and one for services that use the public switched network. We stated that this division mirrors current allocation practices, and would ensure that MTS and WATS services do not subsidize private line.[686] We also stated that this division would simplify administration of access flow throughs.[687] We tentatively found that services using the public switched network would share jointly in the allocation of cost changes, and that the inclusion of cross-elastic services within the same basket would minimize the possibility of pricing distortions.[688]

338. In the Further Notice we tentatively concluded that a single basket alone is insufficient to protect ratepayers and that pricing bands, limiting annual movement in prices, are necessary to prevent rate churn and unconstrained cost-shifting.[689] We stated that bands would protect consumers against excessive price changes during any annual price cap tariff filing period, and would provide some protection to AT&T's competitiors against injurious pricing actions.[690] We also tentatively concluded that bands would permit AT&T a certain amount of freedom to adjust to new market or technological conditions.[691] The Further Notice proposed a 5 percent upper

---

683 Further Notice, 3 FCC Rcd at 3352 (para. 278).

684 Id.

685 Id. at 3352 (para. 279).

686 Id. at 3353 (para. 281).

687 Id.

688 Id.

689 Id. at 3355 (para. 284).

690 Id. at 3355 (para. 285).

691 Id. at 3356 (para. 286).

and lower limit on annual rate changes for each rate element.[692] We proposed a refinement to the lower band in the form of a "no credit zone"; we stated that price decreases greater than 5 percent would be permitted, but not credited for the purpose of determining compliance with the overall aggregate cap. We reasoned that this "no credit" rule would permit rate reductions that would benefit consumers while ensuring that these reductions could not be compensated for by increases in other services.[693]

339. Finally, we solicited comment on whether we should apply more focused pricing rules to MTS services used by residential and small business customers. We asked interested parties to discuss alternatives that would provide further safeguards to basic MTS users, and to comment on whether the benefits of such protections justify the additional constraints they would place on AT&T's flexibility to adjust rates in response to changes in market or technological conditions.[694]

ii. Pleadings

(a) Baskets

340. Although there is widespread support for a baskets and bands approach, few parties endorse the two basket approach for AT&T proposed in the Further Notice. Only CCIA supports the present plan; AT&T does not oppose the two baskets, providing that the proposed system of bands is removed, or at least modified.[695] Two states and US Sprint criticize this Commission's explanation of the reasons for the plan proposed in the Further Notice. Arkansas PSC seeks a more explicit justification of this Commission's proposal, and Illinois asks for a demonstration that the two basket configuration will protect consumers of demand-inelastic services.[696] US Sprint argues that there is little advantage to mirroring current allocation practices reflected in the Interim Cost Allocation Manual for AT&T, and that many high-end switched services are cross-elastic with private line services. US Sprint contends further that the baskets and bands must do more than ensure that AT&T does not use MTS and WATS to cross-subsidize private line services.

---

692 Id. at 3356-57 (para. 287).

693 Id. at 3357-58 (para. 289).

694 Id. at 3357 (para. 288).

695 CCIA Comments at 8; AT&T Comments at 9. AT&T would modify this Commission's proposal in one additional respect, by removing Tariff 11 from price cap regulation. AT&T Comments at 9 n.**.

696 Arkansas PSC Comments at 3; Illinois Comments at 19.

US Sprint states that baskets should be designed to prevent all cross-subsidies. Finally, US Sprint argues that although this Commission stated that the baskets were designed in part to simplify access flow throughs, additional baskets would not introduce complexities because the price cap formulas already require carriers to provide information at a sufficiently detailed level to administer flow throughs to any number of baskets.[697]

341. Many parties, including state commissions, customers, and AT&T's competitors, support further disaggregation of the baskets.[698] Most of the parties arguing for further disaggregation contend that the current basket and band combination permits cross-subsidization.[699] EDS asserts that the broad baskets proposed in the Further Notice may mask cross-subsidization, injuring users in the short run, and AT&T's competitors in the long run.[700] Illinois argues that the degree of consumer protection provided by the price cap plan depends not only on the number of baskets, but also on the composition of each basket.[701] AT&T's competitors contend that cross-subsidization is possible because services within each of the proposed baskets are subject to different levels of competition.[702] US Sprint also argues that if competitive and non-competitive services are in the same basket, predation is costless.[703] AT&T responds that the entire interexchange market

---

697 US Sprint Comments at 21-23.

698 See, e.g., ACTA Comments at 3-4; Cable & Wireless Comments at 28; Ad Hoc Comments at 39; API Comments at 17; New York DPS Comments at 16; Wisconsin PSC Comments at 6; IDCMA Comments at 44-46; Michigan PSC Comments at 13. Wisconsin PSC states, however, that as the number of baskets increases, the appropriateness of existing rates becomes more critical. Wisconsin PSC at 6.

699 See, e.g., ACTA Comments at 5; ALC Comments at 8-9; Cable & Wireless Comments at 27; Comptel Comments at 13-14; MCI Comments at 63; PRTC Comments at 14-15; NTN Reply at 26; Maryland PC Reply at 9; TCA Reply at 14; Wisconsin PSC Comments at 6.

700 EDS Comments at 10.

701 Illinois Comments at 18-19. See also CFA Reply at 6 (inadequate number of baskets permits rate increases).

702 Cable & Wireless Comments at 27; Comptel Comments at 14; NTN Comments at 12; US Sprint Comments at 9; PRTC Reply at 3.

703 US Sprint Comments at 15.

is effectively competitive, and that predation is highly unlikely.[704] Cable & Wireless, however, argues that even if "classic predation" does not occur, the proposed baskets permit AT&T to use its pricing flexibility to discipline its competitors.[705]

342. Parties allege a lack of competition in specific service areas, including international, 800 Service, residential MTS, Dataphone Digital Service (DDS), and voice grade private line. These parties generally favor segregating the services they view as non-competitive in separate baskets. MCI states generally that international MTS (IMTS) is not competitively provided.[706] US Sprint elaborates, arguing that no other carrier can match AT&T's foreign operating agreements, and that MCI and US Sprint provide much of their service by reselling AT&T's service.[707] ICA contends that facilities-based competition for international services has not yet matured.[708] In response, AT&T argues that competing carriers are able to serve countries representing 80 percent of AT&T's post-settlements international revenues, and that AT&T has a declining share of the IMTS market.[709]

343. AT&T's competitors also argue that there is no serious competition in the provision of 800 Service.[710] US Sprint contends that until the 800 database is completed, customers cannot switch carriers and retain their 800 numbers, and competing service providers have difficulty persuading AT&T

---

704 AT&T Reply at 9; AT&T Comments, App. A (statement of Philip Areeda on the unlikelihood of predatory pricing).

705 Cable & Wireless Reply at 6-10. Cable & Wireless describes textbook predation as the case in which AT&T prices below cost in order to drive its competitors out of the marketplace, and enjoy monopoly profits. Id. at 6. Cable & Wireless argues that AT&T could also engage in strategic behavior to shape the industry structure to its advantage and the disadvantage of its customers. Cable & Wireless contends that one of AT&T's primary options is below-cost pricing used to deter entry by new firms and discipline competitors. Id. at 8-9.

706 MCI Comments at 63-64.

707 US Sprint Comments at 24-25.

708 ICA Comments at 22-23.

709 AT&T Reply at 11-12.

710 ALC Comments at 9; MCI Comments at 63-64; PRTC Reply at 21 n.20.

customers to switch carriers.[711] In response, AT&T argues that MCI, US Sprint, and Teleconnect/Southernnet provide nationwide 800 Service, and that the vigorous competition for new customers constrains AT&T's ability to raise prices.[712]

344. Carriers and CFA allege that there is not much competition for residential MTS. GTOC contends that residential customers have few alternatives,[713] while US Sprint simply argues that residential customers are not fully aware that alternatives to AT&T exist.[714] ACTA argues that residential customers have a built-in bias toward AT&T and are generally less sophisticated in purchasing long distance service.[715] CFA contends that special protections for evening and night/weekend rates are necessary.[716] In addition, MCI and US Sprint state that there is not much competition in the provision of operator services.[717] AT&T replies that it faces substantial competition in the provision of MTS service, and that its market share has dropped to 68 percent. AT&T states that 82 percent of the Nation has equal access, and that geographic rate averaging protects rural customers.[718] AT&T also contends that in the area of operator services it faces competition from MCI and US Sprint, as well as from alternative operator service providers.[719]

345. Parties also allege that the provision of certain private line services, including Digital Dataphone Service (DDS)[720] and voice grade, are not competitive. API argues that only AT&T provides voice grade on a ubiquitous basis, and that demand for voice grade services is declining.[721]

---

711 US Sprint Comments at 25-27.

712 AT&T Reply at 10-11.

713 GTOC Comments at 5-6.

714 US Sprint Comments at 25-26.

715 ACTA Comments at 5 n.7. See also PRTC Reply at 3 (AT&T has particularly high levels of market power for residential MTS).

716 CFA Comments at 23-24.

717 MCI Comments at 63-64; US Sprint Comments at 25 n.9.

718 AT&T Reply at 12-13.

719 Id. at 18 n.**.

720 MCI Comments at 63-64.

721 API Comments at 20-22.

IDCMA states that this Commission has previously found that AT&T has a significant market position with respect to 800 Service, international MTS, and certain types of terrestrial private lines.[722] IDCMA argues that AT&T has a large share of the private line market, and that for customers that need central office bridging, redundant capacity, or alternate routing, AT&T is often the only available supplier.[723] AT&T responds that the provision of digital private line services is competitive, and that numerous carriers compete in the provision of analog services.[724]

346. Parties argue that the less-competitive services they have identified create a potential for cross-subsidization, and that bands are not adequate to forestall anti-competitive behavior. These parties conclude that there is a need for further disaggregation of the baskets.[725] US Sprint acknowledges that this Commission could reduce the likelihood of predation by tightening the bands, but suggests that this cure would result in other undesirable "rigidities." US Sprint argues that the better approach is to create separate baskets for less competitive services.[726]

347. In general, AT&T's competitors favor further disaggregation of the switched basket, while large users argue for further disaggregation of the private line basket. US Sprint and Cable & Wireless support separate caps for IMTS, MTS, and 800 Service.[727] Cable & Wireless proposes that, at a minimum, FDC-tested and net revenue-tested services be placed in separate baskets.[728] US Sprint contends that competitive services should not be capped at all, and that they should be separated from non-competitive services.[729] In addition, US Sprint proposes variations on its basic

---

722 IDCMA Comments at 34 (citing Furnishing of Customer Premises Equipment and Enhanced Services by AT&T, CC Docket No. 85-26, Order, 102 FCC 2d 655, 674 (1985); Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), CC Docket No. 85-229, Report and Order, 104 FCC 2d 958, 1026-27 (1986)).

723 IDCMA Comments at 36-37.

724 AT&T Reply at 16-18.

725 See, e.g., MCI Comments at 64 n.99; EDS Comments at 10.

726 US Sprint Comments at 19-20.

727 US Sprint Comments at 28; Cable & Wireless Reply at 11.

728 Cable & Wireless Comments at 28.

729 US Sprint Comments at 10.

proposal, including separate caps for day, evening, and night/weekend rates, or tighter bands for IMTS, MTS, and 800 Service.[730] GTOC argues that this Commission should establish a separate basket for MTS, and require that AT&T maintain the current rate structure, including the discounts for evening and night/weekend rates.[731] ACTA and PRTC argue that residential MTS should be in a separate basket from business MTS, lest residential services be used to subsidize business services.[732] ACTA and PRTC propose five baskets: (1) business MTS and WATS; (2) residential services; (3) IMTS; (4) analog private line; and (5) digital private line.[733] Wisconsin PSC argues for at least one additional basket for services that are not fully competitive.[734] Illinois states that the number of baskets and the grouping of services define carrier pricing flexibility and customer protection from cross-subsidization.[735]

348. Large users concentrate on the disaggregation of the private line basket. TCA argues that the baskets proposed in the Further Notice would permit AT&T to engage in strategic pricing and improper customer migration.[736] Ad Hoc, TCA, and EDS argue for four baskets: business switched, residential switched, analog private line, and other private line.[737] API's first choice is service specific caps, but as an alternative, it favors two private line baskets: analog, which it considers non-competitive, and digital, which it considers competitive.[738] ICA proposes four baskets: switched, analog, high capacity digital, and all other digital.[739] IDCMA contends that this

---

730 US Sprint Comments at 29.

731 GTOC Comments at 5-7.

732 ACTA Comments at 6; PRTC Comments at 15.

733 ACTA Comments at 8; PRTC Comments at 8.

734 Wisconsin PSC Comments at 6.

735 Illinois Comments at 18-19 (baskets should be selected based on relative demand elasticities).

736 TCA Comments at 7-8.

737 Ad Hoc Comments at 39; TCA Comments at 8; EDS Comments at 3, 11. Ad Hoc and TCA would support combining the two switched baskets into one if it would simplify access flow throughs. Ad Hoc Comments at 39 n.31; TCA Reply at 14.

738 API Comments at 17, 20.

739 ICA Comments at 24.

Commission should increase the number of baskets in order to reduce carrier pricing flexibility and carrier opportunity to control the migration of customers from one service to another.[740] IDCMA proposes that separate baskets be established for analog private line, subrate DDS, 56 Kbps service, and 1.544 Mbps service.[741] AT&T argues that additional baskets are unnecessary and would restrict AT&T's flexibility.[742]

349. Several parties comment on the relationship between baskets and access flow throughs. US Sprint contends that more baskets would make access flow throughs more visible, so that AT&T could not favor one group of customers over another.[743] Parties express concern that due to the combination of the composition of the baskets and the allocation of access at the basket level, AT&T could pass through access charge reductions disproportionately to certain services. Both MCI and New York DPS state that exogenous changes, particularly changes in access charges, will affect different services in different ways.[744] MCI argues that this is so because the services within the baskets proposed in the Further Notice do not all use the same mix of access.[745] MCI, Cable & Wireless, GTOC, and the Networks contend that if the allocation of access charges is left to the discretion of AT&T, AT&T will be able to pass through access charge reductions disproportionately to certain services. MCI argues that AT&T could pass through a disproportionate share of reductions to services that face competition, and reduce prices for those services.[746] GTOC, MCI, and Cable & Wireless contend, in particular, that AT&T will not allocate the proper share of access charge reductions to MTS. GTOC contends that AT&T should be expected to pass through to MTS reductions in access charges.[747] MCI and Cable & Wireless argue that AT&T might otherwise pass through reductions in access to WATS or the Optional Calling Plans (OCPs) at the expense of MTS

---

740 IDCMA Comments at 44-45 (stating a preference for individual service caps, while noting that a limited amount of aggregation would be possible).

741 IDCMA Reply at 9.

742 AT&T Reply at 19.

743 US Sprint Reply at 12.

744 New York DPS Comments at 22; MCI Comments at 66.

745 MCI Comments at 66.

746 Id. at 67 n.106.

747 GTOC Comments at 6.

customers.[748] Cable & Wireless also argues that AT&T could manipulate the allocation of access charges between international and domestic MTS.[749] The parties conclude that changes in access charges must be flowed through to individual services.[750] In addition, the Networks argue that this Commission should require AT&T to flow through access charge changes in Tariff 11 in accordance with the existing 10.1 percent rate adjustment formula.[751]

(b) Bands

350. A number of parties comment on the relationship between baskets and bands, arguing that this Commission can impose constraints on carriers either by adding more baskets or by tightening bands. New York DPS, for example, proposes various approaches, including the creation of more baskets (and putting less elastic services in a separate basket with a tighter band), or tightening bands generally.[752] New York DPS and Wisconsin PSC argue that differently composed baskets would permit this Commission to use the bands for fine tuning.[753] US Sprint argues that if this Commission decides not to have separate baskets for evening and night/weekend (ENW) MTS rates, we could establish a 2-3 percent band for MTS.[754] The Networks propose that this Commission either cap television service separately, or tighten the bands on that service.[755] Finally, API, ICA, and TCA assert that the further disaggregation of the baskets reduces the need for lower bands.[756]

351. In explaining their proposals to alter the banding approach set out in the Further Notice, parties discuss the purposes of bands, and whether this Commission's proposal adequately serves those purposes. SWB asserts that bands help prevent rate churn, while IDCMA argues that only upper bands

---

748 MCI Comments at 66-67; Cable & Wireless Reply at 15.

749 Cable & Wireless Reply at 15.

750 MCI Reply at 26-27; US Sprint Comments at 21; Cable & Wireless Reply at 14; New York DPS Comments at 23.

751 Networks Reply at 24 n.43.

752 New York DPS Comments at 18-19.

753 Id. at 16; Wisconsin PSC Comments at 6.

754 US Sprint Comments at 29.

755 Networks Comments at 24.

756 API Comments at 25; ICA Comments at 25; TCA Reply at 16.

are necessary for this purpose.[757] Others contend, however, that 5 percent price increases cumulate quickly, and enable AT&T to restructure its rates with streamlined tariff treatment.[758] Carriers, states, and consumer groups express particular concerns about possible changes in the ENW discount structure.[759] DC PSC, for example, argues that after three years, AT&T could completely eliminate the night and weekend discount without exceeding the 5 percent band.[760] Pactel contends that cumulative rate increases are unlikely, and that evidence of successive increases could be used to challenge within-band, below-cap rates.[761]

352. In the discussion of bands, as in the discussion of baskets, parties focus on the threat of cross-subsidization, and the possibility that AT&T could lower prices for competitive services and raise prices for non-competitive services. Interexchange carriers assert that the current bands permit predatory behavior, to the detriment of both competitors and customers.[762] Cable & Wireless argues that the current bands would slow down, but not stop, predatory behavior.[763] NTN contends that only strict rate element banding will prevent predation.[764] Consumer groups argue that the bands would permit AT&T to raise prices on residential services.[765] Maryland

---

757 IDCMA Comments at 47; SWB Comments at 21-22.

758 ACTA Comments at 10; PRTC Comments at 19-20; Comptel Comments at 17; NTN Comments at 27-28; Michigan PSC Comments at 4; CFA Comments at 23-24; TCA Comments at 10; EDS Comments at 10.

759 ACTA Comments at 10; PRTC Comments at 20; US Sprint Comments at 29; DC PSC Comments at 17-18; CFA Comments at 24; Indiana UCC Comments at 26; Florida's Citizens Reply at 6-7.

760 DC PSC Comments at 18.

761 Pactel Reply at 54 (citing Further Notice, 3 FCC Rcd at 3303 (para. 202)).

762 ACTA Comments at 10-11; PRTC Comments at 20; ALC Comments at 9-10; Comptel Comments at 17-18; US Sprint Comments at 19; NTN Comments at 28; MCI Reply at 21.

763 Cable & Wireless Comments at 29-30 (advocating that price changes be limited to 5 percent over three years).

764 NTN Reply at 25.

765 Colorado OCC Comments at 15; Connecticut OCC Comments at 6-8; Indiana UCC Comments at 24; Michigan PSC Comments at 14; CFA Comments at 20-23.

PC asserts that the current market is oligopolistic, and that existing competition therefore will permit above-cost prices that can be used to fund predatory actions.[766]

353. In contrast, other parties argue that the proposed bands constitute sufficient protection against predation.[767] AT&T, SWB, and CCIA contend that predation is not possible.[768] AT&T argues in the alternative that there are other protections against predation, including the antitrust laws and this Commission's policies on resale and geographic rate averaging.[769] AT&T also argues that even if predation is possible, baskets, upper bands, and the no credit rule are sufficient, and a price floor (below which streamlined review is replaced with a cost-based review) is unnecessary.[770] SWB contends that the no credit rule is arbitrary because below-cost pricing and cross-subsidies may be built into existing rates.[771]

354. AT&T disagrees with its customers and competitors on the question of whether the proposed bands give AT&T too much or too little pricing flexibility. AT&T contends that current rates are FDC-based, and that confining price changes to narrow bands around existing rates perpetuates the inefficiencies created by an FDC-based set of prices. AT&T states that, in particular, MTS rates need to be realigned.[772] IDCMA and MCI argue, however, that a 5 percent band means that prices could be completely unrelated to costs.[773] Comptel also contends that the proposed bands give AT&T too

---

766 Maryland PC Reply at 3.

767 Ohio PUC Reply at 8; IDCMA Comments at 47; Alabama PSC Comments at 4.

768 AT&T Comments at 14-15, App. A; AT&T Reply at 37-38; SWB Comments at 23; CCIA Comments at 10.

769 AT&T Reply at 39-40.

770 AT&T Comments at 16. Later in its comments, however, AT&T states that upper price bands are unnecessary because competition exists. Id. at 18. New York DPS argues that, if competition will keep rates below caps, AT&T should not object to upper bands. New York DPS Reply at 3.

771 SWB Comments at 24.

772 AT&T Comments at 13; AT&T Reply at 51. See also AT&T Reply at 49 n.** (arguing that if the originating and terminating CCL rates are equalized, 5 percent bands will provide insufficient flexibility).

773 IDCMA Comments at 47-48; MCI Reply at 22.

much, rather than too little, flexibility.[774] Finally, a few parties argue that the bands would permit "discrimination," by allowing a 15 percent reduction (over three years) in some rates, and a 15 percent increase in other rates.[775]

355. Both AT&T and its customers contend that lower bands will impede competition, and deny consumers lower prices.[776] AT&T also states that if the PCI shifts the 5 percent bands above existing rates, AT&T would be compelled to raise rates for all services.[777] ACTA, however, contends that absolute (impenetrable) price floors are necessary.[778] Michigan PSC proposes a price floor for each rate element, based on fully-distributed costs.[779]

356. Some parties would introduce greater banding flexibility by applying bands to service prices, rather than to rate elements. AT&T contends that banding by rate element is burdensome, and provides less pricing flexibility than AT&T has today.[780] AT&T states that it has more than 60,000 rate elements, 55,000 of which are in Tariff 11.[781] In addition, AT&T argues that some exogenous changes will affect only certain rate elements, and that banding rate elements will reduce AT&T's ability to respond efficiently.[782] Both AT&T and Pactel state that customers care about services, and not rate elements.[783] These parties, along with Virginia and CCIA, propose that this Commission establish bands around services rather than rate elements.[784] Cable & Wireless, however, argues that rate element banding is

---

774 Comptel Reply at 9.

775 Michigan PSC Comments at 4; Colorado OCC Comments at 15.

776 AT&T Comments at 7, App. B (statement of Lawrence Klein on price bands); AT&T Reply at 36-37; API Comments at 26; Ad Hoc Comments, ETI Report at 10; CCIA Comments at 9; API Reply at 16-18.

777 AT&T Comments at 13-14.

778 ACTA Comments at 21.

779 Michigan PSC Comments at 14.

780 AT&T Comments at 7-8, 10, 20-22.

781 Id. at 10.

782 Id. at 22 n.*.

783 Id. at 21; Pactel Reply at 53.

784 Virginia Comments at 3; CCIA Comments at 10.

technically possible, and cannot be more burdensome than rate of return regulation. Cable & Wireless contends that rate element banding is necessary.[785] The Networks state that banding by service is acceptable, but that it may be more complicated than rate element banding because it will be necessary to define services and develop weighted formulas.[786]

357. Wisconsin PSC and some carriers suggest that bands need not be uniform, but could be tailored to individual services. Wisconsin PSC argues that services subject to little competition, or affected with the public interest, e.g., MTS, should be subject to tighter bands.[787] US Sprint proposes a 2-3 percent band for MTS, and states that this Commission may wish to consider bands of less than 5 percent for 800 Service and international services.[788] AT&T also argues that if this Commission is concerned that there is less competition for certain services, it should establish an upper band for those services, e.g., MTS, or day, evening, and night/weekend MTS.[789] Finally, the Networks propose a specific band on television service of 2 percent up and 5 percent down, with a cumulative limit of 4 percent up.[790]

358. Of the parties commenting explicitly on the proposed 5 percent bands, only Ohio PUC endorses the approach of the Further Notice.[791] NTN and IDCMA argue generally that the bands should be narrower.[792] IDCMA states that

---

785 Cable & Wireless Comments at 28-29; Cable & Wireless Reply at 11.

786 Networks Reply at 18-21. The Networks also argue that if Tariff 11 is excluded from price cap regulation, banding by rate element is considerably less cumbersome.

787 Wisconsin PSC Comments at 5-6.

788 US Sprint Comments at 29.

789 AT&T Comments at 18-19. See also BellSouth Reply at 55; Centel Reply at 12-13. Centel suggests that this Commission could require AT&T to keep the existing ENW discount structure in place. AT&T states in its reply comments that reductions in MTS discounts do not necessarily raise prices paid by residential consumers because these customers do much of their calling during the day, and are benefited by realignments that lower day period rates. AT&T Reply at 49 n.***.

790 Networks Comments at 24-25.

791 Ohio PUC Reply at 8.

792 NTN Reply at 23-24; IDCMA Reply at 9. See also Comptel Comments at 5 (finding that 5 percent bands in addition to the PCI provide AT&T too much

there is no perfect answer to establishing a level for bands, but suggests 2-3 percent to start.[793] ACTA and PRTC advocate upper and lower bands of 3 percent,[794] while Cable & Wireless proposes a 5 percent band over three years.[795] Arkansas PSC, DC PSC, and API ask for further justification of the 5 percent bands.[796] Wisconsin PSC regards the choice of 5 percent as a Commission judgment that reflects the "level of comfort" with the price cap proposal.[797] Several states and consumer groups support more downward than upward flexibility. Missouri PSC, Colorado OCC, and Indiana UCC favor a 0 percent upper band; Missouri PSC also specifies a 10 percent lower band.[798] Rather than bands, Ad Hoc and ICA propose Commission monitoring of "residential price checks," and "target floors" of 10-15 percent for each service, which would trigger Commission scrutiny.[799] Finally, New York DPS argues that the band should apply only to the portion of the rate attributable to changes in direct costs as the carrier is only at risk for this portion.[800]

iii. Discussion

359. If our only concern in implementing incentive regulation were economic efficiency, we could establish one basket for all AT&T services, and no bands. In purely economic terms, customers as a whole would be at least as well off as they would be with any other combination of baskets and bands, because prices in the aggregate could not exceed the cap. This structure also would present to the firm the incentives to pursue price changes that will recover total company costs while concomitantly reducing the loss in consumer surplus. However, economic efficiency is but one of this

---

flexibility).

793 IDCMA Comments at 48.

794 ACTA Comments at 11; PRTC Comments at 21.

795 Cable & Wireless Comments at 29-30.

796 Arkansas PSC Comments at 3; API Comments at 25; DC PSC Comments at 17.

797 Wisconsin PSC Comments at 5-6.

798 Missouri PSC Comments at 8; Colorado OCC Comments at 29; Indiana UCC Comments at 25-26. See also New York DPS Comments at 18 (significant increases above the cap should be limited for inelastic services).

799 Ad Hoc Comments at 39-40, ETI Report at 9-10; ICA Comments at 25.

800 New York DPS Comments at 23-24.

Commission's concerns. We also undertake to minimize the possibility of cross-subsidization and predation, both to protect residential and small business customers, and to foster competition that benefits all ratepayers. In the Further Notice, we proposed two baskets, one for switched and one for private line services. In employing the two-basket approach, the Further Notice relies heavily on bands to prevent predation. The pleadings in response to the Further Notice suggest that a different combination of baskets and bands would better balance our concerns about economic efficiency, ratepayer protection, and predation. We agree that modifications to our proposal should be made.

360. The record reflects widespread agreement that this Commission should take explicit steps to afford extra protection to residential and small business customers. In addition, the record now contains a far greater consensus on which services are subject to varying degrees of competition than was reflected in the record accumulated in response to the initial Notice. Parties generally agree that those services that are presently subject to less competition should receive some form of special treatment in the design of baskets and bands. As many parties noted, baskets and bands are to some extent substitutable, and different combinations of baskets and bands can be used to address the same concerns. We conclude that our baskets and bands approach can and should be tailored to give AT&T less flexibility in its pricing of residential and various less competitive services, and greater flexibility to price efficiently in more competitive areas.

361. We conclude that services used primarily by residential and small business users should be in a separate basket, so that AT&T will not be able to raise prices for these services in order to lower prices for services that larger business customers use. A separate basket also means that residential and small business customers will be assured of their full share of access flow throughs. In addition, we find that rate element banding is not required to protect customers. In lieu of rate element banding, we define narrow service categories in this basket, and require AT&T to calculate a service band index of aggregate rate element prices for each category.[801] We establish limits on upward and downward pricing flexibility by limiting the amount the service band index can move each year, and permit AT&T less pricing flexibility in two service categories that are heavily used by residential customers. Finally, we require AT&T to calculate an average residential rate, and we permit this rate to increase no more than one percent per year relative to the price cap index. Since the productivity factor embedded in the PCI operates to exert downward pressure on rates of 3 percent per year, the pricing constraint we place on the average residential rate has the effect

---

801 A technical description of the service band index is presented in Section III.C.3.c, infra.

of causing AT&T's average residential rate to fall 2 percent per year in real (inflation-adjusted) terms, absent exogenous cost changes. So long as AT&T proposes rates within the cap and band limitations, its tariffs will be given streamlined review.[802]

362. Our decision to separate residential and small business services into their own basket leaves open the regulatory treatment of those services used predominantly by larger business customers. The record demonstrates that substantial barriers to entry remain in the 800 Service market and continue to impede competitive provision of 800 Service. Therefore, we establish a second separate basket for 800 Service with 5 percent upper and lower bands on each service category. We have also examined the remaining AT&T services to determine if further disaggregation is required, and have weighed the arguments for additional baskets against the need to design a system capable of attaining the economic and pricing efficiencies we seek. We find that the remaining services are generally provided to large users, and that much of the competitive activity in the interexchange market involves these services. We therefore conclude that these remaining services should be contained in a single basket, subject to service category banding limitations.

(a) Residential and small business basket

363. This Commission has a longstanding commitment to the protection of residential customers, and the lowering of residential rates.[803] One of the four primary goals of the access charge proceeding is the realization of universal service -- making telephone service available to every residential customer.[804] In pursuit of this goal, we have established a lifeline assistance program to preserve and promote subscribership among low income households, and expanded those programs with the recent addition of Link-Up America, which helps lower the cost of initial connection charges for

---

802 See Section III.C.4, infra.

803 See MTS and WATS Market Structure, CC Docket No. 78-72, Memorandum Opinion and Order, 97 FCC 2d 682, 683 (1983) (one of primary objectives of this docket is the preservation of universal service); MTS and WATS Market Structure and Amendment to Part 67 of the Commission's Rules, CC Docket Nos. 78-72 and 80-286, Recommended Decision and Order, 49 Fed. Reg. 48,325 (1984) (recommending universal service fund to provide assistance to high cost companies); Report and Order, 2 FCC Rcd 2953 (1987) (establishing Link-Up America lifeline program) (hereinafter Depooling Order).

804 See MTS and WATS Market Structure, CC Docket No. 78-72, Memorandum Opinion and Order, 97 FCC 2d 834, 835 (1984).

qualified subscribers.[805] We intend to preserve these special consumer-oriented policies. Indeed, our continued commitment to residential customers has already been demonstrated in this proceeding by the establishment of the Consumer Productivity Dividend, which will stimulate AT&T to generate productivity gains in excess of historical experience, and will exert significant downward pressure on prices each year.[806]

364. In keeping with our policies of protecting consumer interests, we find that a separate residential and small business basket[807] will aid us in ensuring that rates for residential and small business customers remain within the zone of reasonableness. A separate basket protects residential customers by securing them against rate increases designed to permit AT&T to lower prices for other services. In addition, because we are also adopting an access flow through rule that provides for allocation of access charge changes at the basket level, a separate basket guarantees that residential customers will benefit from their full share of future reductions in access charges. We have also decided to impose two additional constraints on the residential basket that will further ensure that the needs of residential and small business users are met. First, we will divide the basket into six narrow service categories: (1) Domestic day; (2) Domestic evening; (3) Domestic night/weekend; (4) International MTS; (5) Operator and credit card services; and (6) Reach Out America.[808] AT&T forfeits streamlined treatment if it raises the rates of Domestic evening or Domestic night/weekend by more than 4 percent, or raises the rates of any other service category by more than 5 percent per year after adjusting for the percentage change in the PCI. AT&T can lower its rates in all these categories a maximum of 5 percent per year, relative to the price cap index, without forfeiting streamlined review. In addition, we require AT&T to ensure that the average residential rate per minute does not increase by more than 1 percent per year above the PCI. Our decision to create a residential and small business basket, and the limitations we have placed on it, are explained below.

365. The single force most responsible for driving down long distance rates over the last several years has been the reduction of access charges long distance companies pay to local exchange carriers. In order to continue

---

805 Depooling Order, 2 FCC Rcd at 2958.

806 See Section III.C.1, supra.

807 For the sake of convenience, we also refer to this basket as the residential basket.

808 Except for Reach Out America, which is designed for residential customers, all other AT&T optional calling plans are in the third basket.

the process of lowering residential rates, we must ensure that AT&T allocates the proper proportion of reductions in access costs to its residential services. We conclude that the placement of residential services in a separate basket helps guarantee proportionate access flow throughs to residential customers.

366. Parties have argued that the combination of the allocation of access charge changes at the basket level, and the broad baskets proposed in the Further Notice, give AT&T too much flexibility in allocating access charge reductions. They propose a service-by-service allocation rule as one solution. While we agree that it is imperative that reductions in switched access charges be flowed through to MTS customers, we believe that a separate basket for residential customers better serves this purpose. The operation of our PCI formula, which measures cost changes within a basket, and the creation of the separate residential services basket, ensure that the proper share of access charge reductions are flowed through to MTS customers.[809] In the case of a downward movement in the PCI caused by an access charge reduction, aggregate prices for all services in the basket must shift downward to accommodate the new PCI level, a result that is approximately equivalant to a service-by-service flow through rule, given the limited pricing flexibility of the pricing bands we have created. This conclusion is buttressed by the rule we adopt to require AT&T to allocate all exogenous costs, including access costs, on a cost causative basis among baskets.[810] Neither WATS nor the optional calling plans are in the same basket as MTS. Thus AT&T will be unable to shift the benefits of access charge reductions from MTS to these services.[811] Cable & Wireless has also alleged that AT&T could misallocate access charge reductions between international and domestic MTS. It is not reasonable to expect that AT&T would use access charge reductions attributable to domestic MTS, a service for which there is competition, to reduce prices for IMTS, a service that is less competitive. Thus, a requirement that AT&T flow through access charge changes on a service-by-service basis is unnecessary as a means of preventing misallocation.[812] Moreover, a requirement

---

809 See Section III.C.1.e, supra.

810 See new Section 61.44(c) & (d) of this Commission's Rules, Appendix B.

811 There is one optional calling plan, Reach Out America, in the residential services basket. As Reach Out is a residential service, AT&T cannot manipulate access charge flow throughs in a way that will disfavor residential customers as a group.

812 While we decline to adopt a rule requiring service-by-service flow throughs of access charge changes, we repeat our statement, made in the context of discussing exogenous cost changes due to separations, that we would give serious consideration to a petition for investigation of a below-cap filing, or to a complaint, if it appeared that cost changes had been applied

that AT&T flow through access charge changes to each service would have an effect similar to capping each service. In the Further Notice, we explained that we had rejected service caps because they might lock in or encourage inefficiencies in pricing.[813] We have similar concerns about requiring access flow throughs on a service-by-service basis.

367. In our discussion of baskets and bands in the Further Notice, this Commission discussed the possibility of cross-subsidization and predatory pricing. Many parties have also argued that baskets and bands ought to be constructed in a way that would preclude predation of competitors by AT&T. AT&T describes predation as below-cost pricing by one seller with the intention of driving competitors from the market and then recouping predatory losses by later raising prices above competitive levels.[814]

368. We do not rule out the possibility of predation on the part of AT&T, and we conclude that the threat of predatory pricing is one that is best addressed in a structural manner as part of price cap regulation. By our selection of baskets, we believe we have chosen an approach that will discourage predation. Because residential services are in baskets separate from all other services, AT&T cannot raise prices on residential services as a group in order to lower prices on any other service without making more extensive showings we require for above-band and above-cap rates. We further limit AT&T's ability to lower prices by adopting lower limits on AT&T's ability to drop its rates, while remaining eligible for streamlined review. Should AT&T lower the price for a service category, as represented in downward movement in the service band index, by more than 5 percent relative to the movement in the price cap index, we will not grant streamlined treatment to such a filing. Longer notice periods apply, and support materials must be filed.[815]

---

to one service in a manner so manifestly unfair as to render rates for that service possibly unreasonable.

813 3 FCC Rcd at 3255-56 (para. 285).

814 AT&T Comments at 14-15, App. A. Cable & Wireless contends that AT&T could engage in strategic pricing, or "price discipline," without engaging in "classic predation." Cable & Wireless describes strategic behavior as shaping industry structure to the advantage of AT&T and the disadvantage of its competitors by increasing the risk and cost of entry or expansion. Cable & Wireless suggests that AT&T could use below-cost pricing to deter entry by new firms and discipline existing competitors. Cable & Wireless Reply at 6-10.

815 See Section III.C.4, infra.

369. In arguing for special treatment of certain services, various of AT&T's competitors and customers contend that there are still institutional barriers to competition in these services. In this proceeding, we set out to develop a better form of regulation for dominant carriers. We did not seek, nor do the pleadings provide, a record sufficient to find that either the interexchange market or any submarket thereof is fully competitive. What the latest round of pleadings does provide is a useful discussion of what services should receive special treatment in the context of the baskets and bands approach that implements price cap regulation. Parties have alleged that there is less than full competition for the following services used by residential customers: residential MTS, operator and calling card services, and international MTS.

370. We conclude that for basic MTS, barriers to entry appear to be low, and competition appears to be growing. As of March 1988, over 500 companies provided interexchange service to some part of the Nation. There are several facilities-based carriers that provide national service, as well as a larger number of facilities-based regional carriers. The principal institutional barrier to competition in the basic MTS market, the unavailability of equal access, is rapidly disappearing. Eighty-eight percent of the Nation's telephone lines have now been converted to equal access.[816] Furthermore, as a result of our geographic rate averaging policy, the existence of submarkets in which equal access is not yet available cannot be exploited by AT&T. This Commission has also eliminated the barrier to entry posed by tariff restrictions on resale, through our policy prohibiting restrictions on resale and shared use.[817]

371. There do, however, appear to be barriers to fully competitive provision of international MTS and operator services. In order to provide international MTS service to a given country, a carrier must obtain an operating agreement with the telecommunications administration (generally a governmental entity) of that country. We have previously expressed concern about the barriers to entry presented by this process, and we have noted that there is a large difference in the number of operating agreements obtained by AT&T, and by its principal competitors, MCI and US Sprint.[818] In addition, as

---

816 "Trends in Telephone Service", Industry Analysis Division, FCC (Feb. 15, 1989) at 12.

817 Resale and Shared Use of Common Carrier Services, Report and Order, 60 FCC 2d 261 (1976), modified on recon., 62 FCC 2d 588 (1977), aff'd sub nom. American Telephone and Telegraph v. FCC, 572 F.2d 17 (2d Cir.), cert. denied, 439 U.S. 875 (1978).

818 See Regulatory Policies and International Telecommunications, CC Docket No. 86-494, Report and Order and Supplemental Notice of Inquiry, FCC 88-71, released Mar. 25, 1988, 53 Fed. Reg. 12,546 (April 15, 1988) at para. 80.

a practical matter, MCI and US Sprint provide international service in large part by reselling AT&T's service.[819]

372. We have also concluded that, although the situation is evolving, certain structural barriers currently limit competition in the area of operator services and credit cards. At present, there is no equal access for public telephones. A 0+ interLATA call from a BOC-owned payphone will be routed automatically to AT&T.[820] The U.S. District Court for the District of Columbia recently approved, as an interim solution, presubscription by the owner of the premises on which the public telephone is located. The Court ordered the BOCs to mail ballots by January 1, 1989.[821] The Court stated, however, that owner presubscription is not a satisfactory long term solution, and the Court would revisit the issue of equal access for payphones at some future date.[822] Approximately 50 percent of 0+ traffic involves calling cards.[823] AT&T and the BOCs share the database required to validate AT&T and BOC calling cards. No other interexchange carrier presently receives database information from the BOCs.[824] Hence, AT&T, but not US Sprint, can validate a BOC calling card, and US Sprint has stated that it must turn away calls dialed on presubscribed phones if the customer wishes to use a BOC calling card.[825] The Court has also ordered the BOCs to cease discriminating in favor of AT&T in the provision of validation data on or before January 1, 1989.[826] Although the situation with respect to operator services appears to be changing rapidly, we conclude that even after presubscription of public telephones is complete, barriers to competition will remain, pending our revisiting of the issue by the Court or this Commission.

---

819 US Sprint Comments at 24.

820 United States v. Western Electric, Civ. Action No. 82-0192, slip op. at 32 (D.D.C. October 14, 1988) (hereinafter October 14 Opinion).

821 Id. at 47-50.

822 Id. at 50-52.

823 Id. at 3.

824 Id. at 13.

825 Motion of the United States for an Enforcement Order Relating to BOC Calling Card Practices at 17, United States v. Western Electric, Civ. Action No. 82-0192 (filed Jan. 28, 1988).

826 October 14 Opinion at 16.

373. We recognize that there may be different levels of competition for services we have placed in the residential services basket. Nevertheless, we believe that isolating these services in a single basket will serve the interests of residential customers. One of our primary concerns is keeping residential rates down, and residential customers use international MTS and operator services as well as domestic MTS and Reach Out America. In the Further Notice, we recognized that basic MTS is used principally by residential and small business customers.[827] Residential customers are significant users of day, evening, and night/weekend MTS.[828] Reach Out America, an optional calling plan that makes available to customers a block-of-time option for MTS, is intended for residential customers.[829] Sixty-seven percent of international MTS calls are charged to residential phones.[830] Residential customers are also heavy users of operator and calling card services.[831] The sets of customers for each of the services in this basket thus overlap to a substantial degree. It is difficult to see how AT&T could manipulate the prices of services in the residential basket to the detriment of residential customers as a class.

374. To address any residual concerns about cross-subsidization and other price manipulation by AT&T detrimental to its competitors, as well as to prevent large rate increases for any service in a particular year, we will band each service category.[832] We conclude that banding by service category, rather than by rate element, will give AT&T the flexibility it requires to allocate costs and price efficently, while still protecting customers from large rate increases and rate churn. A number of parties advocate banding by service, rather than by rate element. Indeed, banding by

---

827 3 FCC Rcd at 3357 (para. 288).

828 AT&T Reply at 49 n.***.

829 See Letter from W.E. Lind to Secretary, FCC, accompanying AT&T Tariff F.C.C. No. 1, Transmittal No. 1223 (May 19, 1988) (introducing day option for Reach Out America).

830 See Letter from G. Morlan, AT&T, to Legal Assistant to Chief, Common Carrier Bureau, Oct. 24, 1988.

831 Id.

832 We define bands relative to the overall change in the PCI. Thus, the price index for most service categories may increase or decrease by 5 percent relative to the change in the PCI or, in the case of Domestic evening and night/weekend MTS, increase by only 4 percent relative to the PCI. Bands represent limits on the availability of streamlined tariff review, rather than absolute pricing limits. See Section III.C.4, infra.

rate element appears unnecessary from a ratepayer perspective, as customers are interested only in the price of the service. In addition, a band that cumulates in a meaningful limit on service price increases may be too restrictive if it is applied at the rate element level, particularly if exogenous changes only affect certain rate elements. Banding by service category is a more sensible means of protecting ratepayers and competitors while enabling AT&T to realize greater efficiencies in cost allocation and pricing.

375. A number of parties also propose that bands vary by service, specifically that tighter bands be imposed on residential services. Another way of reaching the result sought by the advocates of variable banding is to vary the service category that is banded, rather than the numerical value of the band itself. Therefore, in the residential services basket, we have established narrow service categories; day, evening, and night/weekend MTS are all separate service categories. In addition, we have established separate categories for the other services in the basket: international MTS, operator services, and Reach Out America. We believe that our solution, focusing on the structure of baskets and the separation of narrow service categories, to a great extent responds to the concerns of those who would have us impose narrower numerical bands on residential services.

376. There are two service categories, however, that we believe warrant special concern, and merit the imposition of less pricing flexibility. Both evening and night/weekend MTS, which are predominantly used by residential callers, shall be subject to an upward band of only 4 percent per year, relative to the change in the PCI. We believe a tighter constraint on these two service categories is warranted, particularly since there are still a significant number of customers residing in non-equal access, rural areas who have no alternative long distance carrier to turn to should AT&T raise its evening and night/weekend rates. The other categories in the residential basket shall be subject to a 5 percent upward limitation.

377. Finally, as an additional protection for residential customers, we require that the average rate paid by residential consumers for services offered in the residential and small business basket not increase by more than 1 percent per year relative to the change in the PCI. Since the productivity factor embedded in the PCI operates to exert downward pressure on rates of 3 percent per year, the pricing constraint we place on the average residential rate has the effect of guaranteeing that AT&T's average residential rate will fall by 2 percent per year in real (inflation-adjusted) terms, apart from any exogenous cost changes. We conclude that this approach will better protect consumers than will the alternative proposed by Centel and GTOC: freezing the evening and night/weekend discount structure. Residential customers use day, as well as evening, and night/weekend, MTS. If night/weekend rates are close to cost, freezing the discount structure may prevent AT&T from making some reductions in day rates that it would otherwise have made, leaving residential customers as a whole worse off. This Commission's policy for some time has been to permit AT&T to make modest changes in its discount structure,

as cost and demand changes dictate, to enhance the efficient use of its network and to ensure that such rates continue to cover AT&T's costs of providing service. We have chosen to address head-on the issue raised by those who advocate keeping the discount structure in place -- the need for a check on residential rates. Therefore, we require AT&T to develop an average residential rate paid by residential consumers for services in the residential and small business basket, and we establish an annual 1 percent upper band on that average rate.[833]

378. The establishment of a separate basket should prevent AT&T from favoring large business customers at the expense of residential and small business customers, either by diverting access charge reductions, or by raising residential rates in order to lower rates for services designed primarily by large users. The available empirical evidence provides some support for our conclusion that a separate basket for residential services will be of greater benefit to residential customers than would a switched services basket, as proposed in the Further Notice. AT&T has developed a computer model to compare the effects on residential customers of rate of return regulation, and price cap regulation, under both the two-basket approach proposed in the Further Notice, and an approach that includes a separate residential basket.[834]

379. AT&T states that it has designed its computer model to evaluate the relative effects on customers of rate of return regulation and price cap regulation. AT&T's model compares projected prices and revenues if rate of return regulation were continued, to projected prices and revenues under two different price cap plans: the two-basket approach proposed in the Further Notice, and a plan similar to that originally proposed by AT&T[835] that includes a separate basket for residential services. AT&T concludes that customers as a whole would enjoy lower prices under either price cap plan than they would under continued rate of return regulation. AT&T also concludes that the two basket approach of the Further Notice will not necessarily generate lower prices for residential customers but that a separate residential basket will result in prices for residential customers that are lower than they would be if AT&T continued to operate under rate of return regulation.

---

833 We delegate to the Bureau the task of assuring that calculation of the average residential rate is accurate, consistent, and based on reliable statistical methodologies.

834 See Letter from G. Morlan, AT&T to Legal Assistant to Chief, Common Carrier Bureau, Nov. 3, 1988.

835 See AT&T Comments to Notice at 47.

380. AT&T's model permits the user to assign values to variables for the inflation rate, the productivity offset, the growth rate in access prices, the upper band (maximum upward price movements for AT&T services in an annual period), and the annual difference between AT&T's productivity growth and that of the economy as a whole.[836] For the purposes of this submission, AT&T assumes that the inflation rate will be 5 percent, and that the upper band will be 5 percent. AT&T assigns two different values for each of the following variables: the growth rate in access prices, the productivity offset, and the difference between AT&T's productivity growth and that of the economy. This model also presents a scenario hypothesized by certain commenters: that AT&T will raise prices in the evening and night/weekend discount periods by the maximum allowed by the upper band, and lower the prices of other services so that prices overall will be below the cap. AT&T projects the effect on prices for all customers of services in the basket, and the effect on residential customers, for each combination of assigned values. Thus AT&T discusses six "scenarios" for a two-basket plan, and six for a plan with a separate residential basket.

381. Using the model, AT&T predicts that after four years of the two-basket approach of the Further Notice, prices for all services in the switched basket would be between 3.5 percent and 1.1 percent lower than they would have been under rate of return regulation, depending on the assumptions made. AT&T projects that residential customers would see prices that ranged from 1.6 percent lower to 1.1 percent higher than prices under continuing rate of return regulation. If this Commission adopts a plan with a separate residential basket, AT&T anticipates that prices for all services in the residential and small business basket would be lower than rate of return prices by 2.0 to 4.5 percent after four years. AT&T projects that a price cap plan that includes a separate residential and small business basket would result in prices for residential customers that are lower than rate of return prices by 0.8 to 3.3 percent.

382. We have carefully examined the model, and while we have found a few minor methodological errors, we conclude that AT&T's analysis contains no errors of the type that would compel us to reject these results as unreliable. We need not rely on AT&T's specific findings in order to determine that a separate residential basket will assist consumers, but AT&T's findings do provide some empirical evidence in support of our analysis.

---

836 AT&T assumes that the productivity offset selected by this Commission for use in the price cap formulas, and the actual difference between AT&T's productivity growth and the productivity growth of the economy as a whole, will not necessarily be identical.

(b) 800 Service basket

383. Having established a separate basket for services used primarily by residential customers, as well as the additional protections of narrow service categories, the 4 percent upper band limitation on evening and night/weekend MTS service categories, and the 1 percent average residential rate rule, we now turn to services used primarily by business customers. The record establishes that there exist certain structural barriers to competition in 800 Service that are unique to that service, and we therefore establish an 800 Service basket. Until late 1986, AT&T was the sole provider of interstate 800 Service.[837] The provision of 800 Service presents particular difficulties because special number translation functions are necessary -- 800 Service numbers are not "ordinary" numbers.[838] Local exchange carriers currently screen the first six digits of an 800 Service number (800 NXX) and send the call to the carrier to which that NXX is assigned. Because NXXs are assigned to particular carriers, an 800 Service subscriber cannot change interexchange carriers without changing its 800 Service number. In addition, subscribers are limited in their choice of 800 Service numbers to numbers beginning with NXXs reserved for their carrier.[839] The BOCs and some of the independent telephone companies are developing alternative 800 Service access systems that will perform 10-digit screening and permit number portability.[840] In 1986, this Commission adopted a Notice of Proposed Rulemaking to consider the long term obligations of the LECs to provide access services to ICs for their provision of 800 Service.[841] In the 800 Service Notice we tentatively concluded that the 800 Service database plan that the LECs were developing was substantially superior to other forms of 800 Service access, and that we should require its implementation.[842] In 1988, we adopted a Further Notice of Proposed Rulemaking, concluding that additional information was necessary to enable us to determine what regulations, if any, we should adopt for the

---

837 See Provision of Access for 800 Service, CC Docket No. 86-10, Supplemental Notice of Proposed Rulemaking, 3 FCC Rcd 721, 721 (1988) (hereinafter 800 Service Further Notice).

838 Id. at 721. An "ordinary" telephone number refers to a 10-digit number under the North American numbering plan, consisting of a 3-digit area code, and a 7-digit local exchange number.

839 Id. at 722.

840 Id.

841 See Provision of Access for 800 Service, Notice of Proposed Rulemaking, CC Docket No. 86-10, 102 FCC 2d 1387 (1986) (hereinafter 800 Service Notice).

842 Id.

provision of local exchange access for 800 Service.[843] As it is not clear when the 800 Service database will be functional, we err on the side of caution by establishing a separate 800 Service basket.

384. Because 800 Service is in a separate basket, we have also guaranteed that 800 Services will receive their share and only their share of reductions in switched and special access charges. This responds to concerns that access charge changes might be misallocated because some services are more competitive than others, and AT&T might flow through reductions disproportionately to services for which it faces the most competition. By placing the less competitive business services -- the 800 Services --in a separate basket, we have minimized the possibility of misallocation. The second basket, therefore, will contain all 800 Services, in four service categories. Because we have already segregated 800 Services into a separate basket, we see no need for the extraordinary precautions we have taken for residential customers in the form of extra-narrow service categories, and the 1 percent average rate rule. Therefore, the service categories in the 800 Service basket simply represent the stand-alone 800 Services: (1) Readyline 800; (2) AT&T 800; (3) Megacom 800; and (4) all other 800. A 5 percent upper and lower band on each service will prevent extreme movements in price in any given year.

(c) Business services basket

385. We have separated residential services and 800 Services into their own baskets. We have examined the remaining services to determine if further disaggregation is required, and have balanced the arguments for additional baskets with the need to design a system capable of attaining the economic and pricing efficiencies we seek. We find that these business services are generally provided to large users, and that much of the competitive activity in the interexchange market involves these services. We therefore conclude that these remaining services will be contained in a single basket, subject to service category banding limitations. There are seven service categories in the third basket: (1) Pro America I, II, and III; (2) WATS; (3) Megacom; (4) SDN; (5) other switched; (6) voice grade private line and below; and (7) other private line. We conclude that the arrangement of baskets described is the approach best suited to the prevention of predation. Although several large customers allege that some private line services may not be subject to full competition in every part of the Nation, the record does not indicate any institutional barriers to competition of the sort that are present for 800 Services.

---

843 800 Service Further Notice, 3 FCC Rcd at 723.

386. We conclude that further disaggregation of the baskets is unnecessary; indeed it might prove detrimental. Further disaggregation of baskets would increase difficulties in allocating exogenous costs, as well as raising concerns about the appropriateness of the productivity factor to each PCI. Additional baskets could also unduly restrict AT&T's ability to price efficiently.[844] Rather than additional baskets, we believe that bands can be used to provide any necessary supplemental protections. In order to prevent extreme price shifts in any given year, there will be 5 percent upper and lower bands on each category. These bands should also address concerns about strategic pricing and controlled migration of customers. Four of the five categories of switched services we identify for separate banding are simply stand-alone services. We conclude that in this basket, as opposed to the residential basket, special customer protections are unnecessary, and there is no need for further disaggregation of the service categories. However, while our concerns about the provision of voice grade private line service do not rise to the level that would warrant a separate basket, we do think that a more limited form of protection for voice grade customers is necessary. Therefore, voice grade private line is in a category separate from most other private line services, with rate increases and decreases not to exceed 5 percent per year relative to the adjusted PCI.

(d) Bands

387. The Further Notice proposed upper bands, and lower bands in the form of a no-credit rule, as well as more stringent tariff review for rate decreases in excess of 5 percent. While upper bands are necessary because of the need to promote rate stability and protect customers, several commenters argue that lower bands appear unnecessary, and perhaps will be injurious to customers.[845] In general, this Commission prefers not to interfere with rate decreases unless anticompetitive behavior is implicated. The Further Notice relied on lower bands to help address the threat of predatory behavior. In this Order, we address the potential risk of predation at a more fundamental structural level, by isolating less competitive services, and preventing their use as a source of cross-subsidies. Nevertheless, we decide, out of an abundance of caution, to impose an additional check on AT&T's ability to decrease its rates. We therefore require that to qualify for streamlined review, service prices as defined by the service categories established for each of the baskets, may decrease only 5 percent per year

---

844 Cable & Wireless proposes a separate basket for FDC-tested and net-revenue tested services. Although we take a slightly different approach, our solution addresses Cable & Wireless' fundamental concern, which is cross-subsidization.

845 See AT&T Reply at 36-37; API Comments at 26; Ad Hoc Comments, ETI Report at 10; CCIA Comments at 9.

after adjusting for changes in the PCI. Should AT&T propose a service price decrease in excess of 5 percent, that filing shall be subject to a longer notice period and shall compel the filing of additional support materials.[846]

388. We do not retain that portion of our proposal that would deny AT&T credit for price decreases that this Commission permits to become effective. Under the "no-credit" rule proposed in the Further Notice, AT&T could only count the first 5 percent decrease in prices for the purpose of calculating its compliance with the PCI. We believe that if AT&T can support a below-band rate, and we permit that rate to take effect, AT&T should be given credit for the full amount of the decrease.

389. We believe that our redesign of baskets, the decision to impose price "floors," and increased tariff scrutiny for above-band filings, should significantly decrease AT&T's ability to cross-subsidize improperly, and therefore represent a substantial improvement on rate of return regulation. To the extent that the spectre of anticompetitive activity surfaces in the future, parties will continue to have recourse to this Commission through our complaint process and tariff investigations, as well as to the courts. We expect that those of AT&T's competitors that believe they have been injured by predatory pricing on the part of AT&T will file complaints alleging that prices for certain services are predatory. In evaluating those complaints, we will refer, as is our practice, to the relevant antitrust standards. In addition, parties may go directly to the courts and allege that AT&T is practicing predatory pricing, and is in violation of the antitrust laws. Price cap regulation does not disturb, and we continue to rely on, our extensive market rules, including prohibitions on restrictions on resale or availability.[847] In addition, because we have not streamlined review of filings for restructured services, the tariff review process continues to be an avenue available to parties that wish to challenge allegedly anticompetitive restructurings.[848]

390. Some parties also argue that bands should protect against cumulative rate increases. We believe that the use of bands to address cumulative increases is unnecessary because harmful cumulative changes will be forestalled by the construction of the baskets. The basket structure is designed to prevent cumulative increases intended not to increase pricing efficiency but to facilitate predation, and is better suited to that purpose. An additional banding restriction would, we believe, simply constitute an

---

846 We discuss the tariff filing requirements for such below-band rates in Section III.C.4, infra.

847 See Section III.D.2, infra.

848 See Section III.C.4, infra.

unwarranted impediment to AT&T's flexibility to realign rates to promote efficiency.[849]

391. Despite the fairly broad consensus on the need for bands, the latest round of comments is of little assistance in setting the numerical value for the percentage limitation. We conclude that the 5 percent upper bands for most service categories, and the 5 percent lower bands for all service categories, strike a reasonable balance between AT&T's ability to price efficiently, and customers' need for rate stability and regulatory protections.[850] Moreover, the 5 percent figure represents the consensus developed in the initial round of comments in this proceeding.[851] Our choice of 5 percent is buttressed by the fact that since 1984, MTS prices have not increased by more than 5 percent annually, after factoring out access and other exogenous changes.[852] We therefore adopt, with modifications, the proposal contained in the Further Notice to limit annual movement in prices by applying percentage constraints on upward and downward price changes. Unlike the Further Notice, the rule we adopt shall apply to the service categories we have identified among AT&T's baskets.[853]

---

849 Certain consumer groups and states argue that continuing increases in rates for one service accompanied by continuing decreases in rates for another service would automatically constitute discrimination. It is axiomatic that a change in the relative prices of services does not by itself demonstrate unjust or unreasonable discrimination. Of course, persuasive evidence of several rate increases in succession for a particular service, discriminatorily high increases for certain services, or precipitous decreases having an anticompetitive effect would likely warrant requiring a carrier to come forward with additional rate information.

850 As we previously stated, prices for evening and night/weekend MTS are limited by 4 percent upper bands, based on our assessment that these services warrant less upward pricing flexibility.

851 Further Notice, 3 FCC Rcd at 3356-57 (para. 287).

852 New York DPS argues that the band should apply only to the portion of the rate attributable to changes in direct costs, because AT&T is at risk only for these costs. The New York DPS approach is not possible because exogenous costs are allocated only at the basket level, and not by service.

853 As we have previously stated, upward price movement for the average residential rate is limited to 1 percent per year in real (inflation-adjusted) terms.

3. Comparing Proposed Rates to the PCI

a. Operation of the Actual Price Index

i. Summary of Further Notice

392. In the Further Notice, this Commission proposed to measure the movement of AT&T's rates within each basket and to ensure compliance with the limits imposed by each basket's PCI through the mechanism of an actual price index (API).[854] To calculate the API, we designed a base price index (BPI) to reflect the level of each basket's aggregate average rates in effect during a base period, the 12-month period ending six months before the effective date of the annual price cap tariff.[855] By multiplying the BPI value by the ratio of proposed aggregate rates to base period average aggregate rates, we would derive an API value representing the proposed level of revenue-weighted aggregate rates within a basket.[856]

393. We proposed to calculate adjustments to the BPI pursuant to the following formula:

$$BPI = BPI(\text{previous year})[\Sigma_i \, v_i \, (p2/p1)_i]$$

where

BPI(previous year) = the BPI from the base period preceding the most recently completed base period,

p2 = the average price (revenue divided by quantity) of a rate element during the most recently completed base period,

p1 = the average price (revenue divided by quantity) of a rate element during the base period preceding the most recently completed base period,

---

854 Further Notice, 3 FCC Rcd at 3434 (para. 443).

855 Id. at 3438-39 (para. 453).

856 Id. at 3438 (paras. 451-53).

v = the ratio of revenues generated by a rate element during the base period preceding the most recently completed base period to the basket's total revenues during that base period, and

i = the rate elements in the basket.[857]

We proposed to update the BPI once per year at the time of the annual price cap filing.[858] Thus, during each tariff year, the BPI would act as a constant benchmark by which to compare current rates.

394. This Commission proposed that adjustments to the API be calculated as follows:

$$API = BPI\ [\Sigma_i v_i\ (p2/p1)_i]$$

where

p2 = proposed price,

p1 = base period average price (total revenue from the rate element divided by units sold),

v = base period weight, calculated as the ratio of revenues generated by each rate element "i" during the base period to the basket's total revenues during the base period, and

i = the rate elements in the basket.[859]

Under the proposal, each time AT&T filed rate revisions it would be required to adjust the API to reflect those changes. The API, calculated pursuant to this formula, was required to remain at or below the applicable PCI in order for the rate revisions to receive streamlined tariff filing and review treatment.[860]

---

857 Id. at 3522-23 (proposed Section 61.45(b) of this Commission's Rules).

858 Id. at 3439 (para. 453).

859 Id. at 3521-22 (proposed Section 61.45(a) of this Commission's Rules).

860 Id. at 3439, 3441 (paras. 454, 459-60).

ii. Pleadings

395. AT&T contends that the proposed price index formulas do not accurately reflect price changes that are made during the last six months of a tariff year. AT&T argues that because our proposed base period ends six months before the start of the next tariff year, price changes that occur after the base period ends, and during this six-month "lag" period, are not incorporated into the BPI for the upcoming tariff year. AT&T states that price changes occurring during this "lag" period are therefore subject to a one-year delay before they are incorporated into the BPI.[861] As a result, AT&T asserts, the same price change is incorporated directly into the API twice --once at the time the new price is introduced during the lag period, and again at the time of the annual price cap filing in the ensuing tariff year -- at different revenue weights, without having itself contributed to the weighting change through incorporation into the BPI.[862]

396. AT&T complains that this feature of the six-month lag between base period and tariff year, when combined with the use of average base period prices in the API and BPI formulas, results in erratic movement in the API unless a price change is made at the beginning of the base period.[863] The carrier asserts that if a price change occurs in the middle of the base period, the full effect of the change will not be reflected in the subsequent BPI calculation, since it reflects average prices over the base period.[864] AT&T states that the remainder of the mid-base period price change will be reflected directly in a subsequent API calculation, but at a different revenue weight from that used when the price change first appeared.[865] One consequence of this phenomenon, AT&T asserts, is that the price index could change even if no rates change.

397. AT&T states that another consequence of the application of different revenue weights is that the BPI, when calculated, is not the weighted average of the "point-in-time" API values during the base period. This is so, AT&T asserts, because the base period is in effect split between two different tariff years by virtue of the six-month lag. Thus, the API period are calculated using two weights -- those of two base periods ago, during the first half of the year, and those of one base period ago, during

---

861 AT&T Comments, App. C at 5.

862 Id., App. C at 5-6.

863 Id., App. C at 9.

864 Id.

865 Id.

the second half of the year. However, the BPI for the most recently completed base period is calculated using just one weight (that of the base period preceding the most recently completed base period).[866]

398. AT&T's proposed solution to the purported problems it identifies is to eliminate the BPI and devise a single index of point-in-time prices as follows:

$$API_t = API_{t-1} [\Sigma_i \, v_i \, (p_t/p_{t-1})_i]$$

where

API_t = the proposed API value,

API_{t-1} = the existing API value,

p_t = the proposed price for rate element "i,"

p_{t-1} = the existing price for rate element "i," and

v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of the base period demand for the rate element "i" priced at the existing rate, to the base period demand for the entire basket of services priced at existing rates.

AT&T proposes that its base period for determining the demand quantities used in revenue weight calculations should be the most recent 12-month period for which data are available at the time of the annual price cap filing. It states, however, that that period roughly coincides with our proposal to use the 12-month period ending six months prior to the effective date of the annual price cap tariff filing.[867] AT&T contends that its proposed API formula has the virtues of reflecting price changes in a consistent manner and of not changing when prices remain constant.[868]

399. Pactel and United generally agree with AT&T's criticisms of the proposed API and BPI formulas, and they support AT&T's proposed modifications.[869] NYNEX, on the other hand, finds no major methodological

---

866 Id., App. C at 9 n.*

867 Id., App. C at 12 n.*.

868 Id., App. C at 15.

869 Pactel Reply at 46-47; United Reply at 11.

flaw in the API and BPI formulas proposed in the Further Notice. NYNEX states that it is appropriate to update weights when new weights become available, and, given updated weights, one would expect the API to change to reflect the most accurate value of the average price changes.[870] NYNEX does, however, propose a minor modification to the BPI formula, which, it claims, will yield more current results. NYNEX suggests that in making the annual BPI calculation, the weights used should be those of the most recently completed base period, rather than those of the base period before that.[871]

400. GTOC, in an ex parte presentation,[872] expresses concern regarding the manner in which we proposed to calculate average base period prices in the API and BPI formulas (i.e., revenues divided by units sold). GTOC contends that due to uncollectibles, the average price calculated in the manner proposed in the Further Notice would be less than the weighted average of actual prices in effect so long as revenues are defined as revenues received. It argues that since the API calculation compares an actual proposed unit price against the base period average price (calculated as revenues divided by quantities), the ratio would continually overstate the level of a proposed price increase, and understate the level of a proposed price decrease, thus overstating the API.

iii. Discussion

401. We do not find any fundamental flaw in the manner in which the API and BPI formulas proposed in the Further Notice track price movements. The API/BPI configuration accurately measures the difference between current prices and base period average prices, and the purported anomolies to which AT&T and others refer merely reflect the effects of the annual updating of

---

870 NYNEX Reply, App. C at 6-7.

871 Id., App. C at 9-10.

872 See Letter from Assistant Vice President - Regulatory Affairs, GTE Service Corporation, to Acting Secretary, Federal Communications Commission, dated Jul. 13, 1988.

weights.[873] Nevertheless, we conclude for several reasons that we should adopt the alternative API formula proposed by AT&T.

402. First, we find merit in AT&T's assertion that for the purposes it must serve under price cap regulation, the API should not move from one day to the next if there has been no actual rate change during that interval. At the same time, we note that AT&T is not, strictly speaking, correct in its criticism that the API and BPI formulas may result in changes to the API value at the beginning of each tariff year even though no rate changes have been associated with the advent of the new tariff year. Since the price comparison in our proposed formula is being made to base period average rates, and the new tariff year brings with it a new base period average against which the existing rate is compared, the difference between the existing rate and the base period average would change, leading to a new index value. Thus, a change in fact would occur. Nevertheless, this trait has the potential to result in unnecessary rate churn at the beginning of each tariff year if the proposed API pierces the applicable PCI upon recalculation.

403. Second, the single index of point-in-time prices that we are adopting is simpler to apply than the more cumbersome dual index methodology we proposed in the Further Notice. In addition to the simplification of employing one index instead of two, the revised API formula dispenses with the need to calculate average rates (revenues divided by units sold), thus obviating the problem, identified by GTOC, of accounting for the effects of uncollectibles in making the calculation. Finally, the modified API has the advantage of being parallel in structure to the PCI formula we are adopting in this Report and Order for AT&T. Since the proper operation of price cap regulation depends in large measure on the assumption that the API and PCI will accurately reflect relative changes in prices and costs, it seems prudent to use parallel indexing methodologies in the two indexes to ensure that any biases that may exist in the indexes operate in the same direction.

---

873 In this regard, we agree with NYNEX's basic conclusion that there is nothing anomalous about the fact that the process of updating weights can change the value of the index. NYNEX Reply, App. C at 6-7. We disagree, however, with the premise underlying NYNEX's proposal to update the BPI using current base period weights, rather than prior base period weights. Such a formula methodology would be akin to a Paasche index, which we have rejected as being unsuited to price caps. See Sections III.C.1.a and e, supra. Moreover, the NYNEX proposal appears to be offered as a remedy to a purported formula anomoly that does not in fact exist, since it arises only by virtue of NYNEX's incorrect assumption that the API and BPI formulas utilize quantity weights rather than revenue weights. See NYNEX Reply, App. C at 9.

404. Thus, in practice, the API that we are adopting will measure the incremental change in the aggregate price of each basket of services each time AT&T proposes rate revisions. As before, the formula requires the summation of the weighted ratios of proposed prices and former prices. However, unlike the formulas proposed in the Further Notice, the modified formula compares the proposed price in each ratio to the current price, rather than to the base period average price; and the weight attached to each such ratio is updated every time the API is adjusted, rather than remaining fixed during each tariff year based upon actual base period revenues. Under this formula, we retain the same base period -- the 12-month period ending six months prior to the effective date of the annual price cap filing -- as before. However, we do not fix weights according to base period revenues, but rather update weights using base period demand quantities and current prices.

405. Despite the methodological changes in the API we are adopting, the role served by that index will remain the same as proposed in the Further Notice. As before, the overall rates proposed by AT&T will be deemed in compliance with the price cap only if the API is less than or equal to the PCI at all times. Consistent with the Further Notice, if AT&T does not exercise its full pricing discretion in any given year, the carrier is not precluded from utilizing that full discretion, subject to applicable banding limitations, in future years. We continue to believe that to limit fluctuations in the API each year to the precise rate of change in the PCI would discourage AT&T from lowering its rates when current costs or market conditions otherwise warrant, thus limiting consumer benefits.

b. Special Case Rules

i. Summary of Further Notice

406. In the Further Notice, this Commission recognized that it would be necessary to establish separate procedures to incorporate certain "special case" rate changes into the API. First, we proposed that new services, defined as those provided in addition to existing offerings, be brought under price caps at the first annual price cap tariff filing following the completion of the base period in which they are introduced.[874] We proposed that this be done by updating the weights used in calculating the API to include the impact of the new service during the base period, and then by comparing the proposed prices (including those of the new service) to the base period prices (including those of the new service).[875] We tentatively

---

874 Further Notice, 3 FCC Rcd at 3442 (para. 462).

875 Id. at 3442 (para. 463).

concluded that this procedure would ensure that the price cap plan continued to apply to the changing mix of service offerings.[876]

407. Second, we proposed that, unlike the introduction of new service offerings, any attempt by AT&T to restructure services subject to price caps would need to be reflected immediately in the API for the affected basket.[877] We defined restructured services as "those that represent the restructuring of a method of charging or provisioning a service, by changing or adding to a rate structure, or tariff term or condition."[878] This Commission tentatively determined that upon restructuring, the API must measure the resulting change in the total cost of purchasing that bundle of services that consumers actually purchased prior to restructuring. We observed that this calculation would require the use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the restructured service) that will remain or become available upon restructuring.[879]

408. The Further Notice also provided that if AT&T proposed to abandon a service, subject to Commission regulations, a determination must be made of the impact of such abandonment on the API of the affected basket.[880] We tentatively concluded that, as with restructured services, service abandonment would require estimation techniques to assign customers of the abandoned service to the remaining services. We proposed that the API would be recalculated based upon such assignments.[881] Finally, the Further Notice tentatively proposed to adjust the API and, as necessary, the PCI in the event that a capped rate were found unlawful as a result of a tariff investigation or complaint.[882]

ii. Discussion

---

876 Id. at 3442 (para. 462).

877 Id. at 3442 (para. 464).

878 Id. at 3442 (para. 462).

879 Id. at 3442 (para. 464).

880 Id. at 3441 (para. 461).

881 Id.

882 Id. at 3442-43 (para. 465).

409. Although some parties expressed concerns regarding the manner in which we proposed to define new and restructured services,[883] or the cost showing that we proposed in connection with the introduction of new services,[884] or the length of time we proposed to keep new services outside the cap,[885] we did not receive comment specifically addressed to the procedures by which we proposed to incorporate "special case" rate changes into the API. We conclude, however, that the general approaches proposed in the Further Notice for dealing with such rate changes are sound, and, as modified to fit the revised API formula, should be adopted.

410. With respect to bringing new services under price caps, we reaffirm our conclusion that the API should be adjusted to reflect the impact of a new service on a basket's aggregate rates at the first annual price cap tariff filing following completion of the base period in which the new service is introduced. To make this adjustment under the revised API formula we are adopting, the demand for the new service during the base period must be included in determining the weights used in calculating the API.[886] The proportional change between existing prices (including that of the new service) and proposed prices (including that of the new service), weighted according to base period demand and existing prices, is multiplied against the existing API value to produce the new API, which incorporates the new service. We continue to believe that this approach to incorporating new services into price caps will ensure that the new regulatory approach reflects the changing mix of AT&T's services.

411. We also reaffirm our conclusion that the restructuring of services subject to price cap regulation must be reflected in immediate adjustments to the API for the affected basket. Unlike new service offerings, which expand the choices available to consumers, restructuring may limit or otherwise change existing choices. Thus, the impact of such changes must be subject from the outset to the pricing limitations imposed by the PCI, and in order to accomplish this, the API must reflect the impact of those changes. We therefore require that the API calculation convert existing rates into rates of equivalent value under the proposed structure, and then compare the

---

883 See Section III.C.4.f, infra, regarding the tariff review standards we adopt for new and restructured services.

884 See id.

885 See id.

886 As described above, the weight applied to each price ratio in the API formula is derived by taking the ratio of base period demand for the rate element priced at the existing rate, to the base period demand for the entire basket of services priced at existing rates.

existing rates that have been converted to reflect restructuring to the proposed restructured rates. As we noted in the Further Notice, this calculation may require use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the restructured service) that will remain or become available upon restructuring. Since restructuring may occur in many forms, we do not specify in advance the particular data and estimation techniques that must be employed in making the required adjustment to the API. However, we of course retain the right to assess in the tariff review process the techniques AT&T in fact employs to determine their reasonableness.

412. Similarly, we conclude that if AT&T proposes to abandon an existing capped service, subject to Commission regulations, the API must be adjusted immediately to reflect the effects of that abandonment. As with restructured services, this calculation must convert existing rates into rates of equivalent aggregate value excluding the abandoned service, and then compare the proposed rates to those hypothetical converted rates. Like the calculations for restructured services, this calculation may require use of estimation techniques to assign customers of the abandoned service to remaining services.

413. Finally, we adopt the tentative decision proposed in the Further Notice to require such adjustments to the API and PCI as are necessary to reflect the results of investigations or complaints into the lawfulness of capped rates. In particular, if the results of an investigation or complaint affect an existing rate used to calculate the API, or affect an exogenous cost used to calculate the PCI, or the weight attached to either, adjustments must be made to correct the affected indexes.

c. Operation of the Service Band Index

i. Summary of Further Notice

414. In addition to the general ceilings on aggregate rates within each basket, this Commission proposed in the Further Notice to employ rate bands to limit the range within which AT&T could raise or lower individual rate element prices each year while continuing to receive streamlined tariff scrutiny.[887] We tentatively determined that bands for the upcoming tariff year should be calculated at the time of the annual price cap tariff filing;[888] and we proposed to define the bands for each rate element as a 10 percent zone, with the midpoint being the rate element price in effect

---

887 Further Notice, 3 FCC Rcd at 3440 (para. 455).

888 Id. at 3440 (para. 457).

on the last day of the base period, adjusted by the percent change in the PCI.[889] Apart from requiring more exacting tariff review scrutiny of out-of-band filings, we provided that the portion of proposed rate reductions that were below the lower band limits would be ignored in calculating the API, thereby limiting the carrier's ability to raise other rates without exceeding the aggregate pricing limits imposed by the PCI.[890]

ii. Discussion

415. As discussed in Section III.C.2.b, supra, we received substantial comment from parties regarding our banding proposals. In light of that record, and the structural changes we are making to the plan, we have determined that banding by service category, rather than by rate element, would best serve the public interest.[891] Moreover, while we are adopting lower, as well as upper, bands on AT&T's service category rates, we have determined that our proposal in the Further Notice to ignore rate reductions that fall below the lower bands in calculating the API is unnecessary to protect competition and should be abandoned.[892]

416. In order to implement service bands, we direct AT&T to establish subindexes within each basket that measure the movement in the revenue-weighted aggregate price of the group of rate elements that comprises the banded service category. Each such service band index (SBI) shall be calculated using essentially the same formula as we are adopting for the API:

$$SBI_t = SBI_{t-1}[\Sigma_i \, v_i(p_t/p_{t-1})_i]$$

where

---

889 Id. at 3440 (paras. 456-57).

890 Id. at 3441 (para. 458).

891 As noted earlier, at the outset of price cap regulation applied to AT&T, we are requiring bands for the following service categories. In the residential and small business basket, we require bands for: (a) Domestic day; (b) Domestic evening; (c) Domestic night/weekend; (d) International MTS; (e) Operator and credit card services; and (f) Reach Out America. In the 800 Service basket, we require bands for: (a) Readyline 800; (b) AT&T 800; (c) Megacom 800; and (d) Other 800. In the business services basket, we require the following bands: (a) Pro America I, II, and III; (b) WATS; (c) Megacom; (d) SDN; (e) Other switched; (f) Voice grade and below private line; and (g) Other private line. See Section III.C.2.b, supra.

892 See Section III.C.2.b, supra.

SBI_t = the proposed SBI value,

SBI_{t-1} = the existing SBI value,

p_t = the proposed price for rate element "i,"

p_{t-1} = the existing price for rate element "i," and

v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of base period[893] demand for rate element "i" priced at the existing rate, to the base period demand for the entire group of rate elements comprising the service category priced at existing rates.

417. Pursuant to the banding requirements we are imposing, the value of each SBI during a tariff year may not increase or decrease by more than a specified percentage,[894] net of the percentage change in the PCI, from the SBI level in effect on the last day of the previous tariff year.[895] Otherwise, heightened tariff review scrutiny will result. To the extent that services subject to banding are restructured, the effect of such restructuring on the applicable SBI would be calculated using estimation techniques identical to those required in connection with adjustments to the API. As with the API, we also require such adjustments to the SBI as may be necessary to reflect the results of investigations or complaints into the lawfulness of banded services.

---

893 As described in Section III.C.3.a.iii, supra, the "base period" is defined as the 12-month period ending six months prior to the effective date of the annual price cap tariff filing.

894 As described in Section III.C.2.b, supra, the evening MTS and night/weekend MTS service categories are subject to a 4 percent upper band, while all other AT&T service categories are subject to a 5 percent upper band. The lower band for all service categories is set at 5 percent.

895 We find no reason to revise our conclusion expressed in the Further Notice that it is necessary to define bands relative to the overall change in the PCI. See Further Notice, 3 FCC Rcd at 3440 (para. 456). The use of this benchmark ensures that the entire price structure within each basket, and any limits thereon, shifts proportionally with any changes in underlying cost factors.

d. Establishing Initial Index Values

1. Use of Existing Rates Generally

(1) Summary of Further Notice

418. In the Further Notice we tentatively concluded that existing prices are an appropriate starting point for the limited purpose they will serve in the price cap plan.[896] We noted that existing rates have survived scrutiny under tariff review procedures, and that parties have been free to seek suspension or rejection of rates they consider unreasonable through the tariff review or complaint processes.[897] We sought comment on our tentative conclusion that our investigatory and complaint procedures will, in combination with the overall price cap structure, continue to provide an adequate remedy for parties challenging particular rates under price caps.[898] We tentatively concluded that a full scale rate case investigation prior to the initiation of price caps was likely to be unproductive, and a less pragmatic approach than using existing rates.[899] We also tentatively concluded that existing rates provide an initiation point that is superior to the use of a general standard, and that either a stand-alone cost test or an incremental costing standard would be difficult to apply.[900]

419. In the Further Notice, we sought comment on our tentative conclusion that there is no compelling reason to accompany the initiation of price caps with changes either downward or upward in rates.[901] We tentatively concluded that a specific adjustment factor to "squeeze out" unnecessary investment and expense occurring under rate of return regulation was not proper[902] and that the D.C. Circuit's decision in Democratic Central Committee does not compel an initial downward adjustment in rates.[903] We also

---

896 Further Notice, 3 FCC Rcd at 3331 (para. 250)

897 Id. at 3333-35 (paras. 252, 254).

898 Id. at 3334-35 (para. 254).

899 Id. at 3332 (para. 251).

900 Id. at 3338-39 (para. 262).

901 Id. at 3335 (para. 255).

902 Id. at 3336 (para. 256).

903 Democratic Cent. Comm. v. Washington Metropolitan Area Transit Comm., 485 F.2d 786 (D.C. Cir. 1973), cert. denied sub nom. D.C. Transit System v. Democratic Cent. Comm., 415 U.S. 935 (1974). See Further Notice at 3336

sought comment on a proposal to apply a downward rate adjustment factor to existing rates, although we limited this proposal to the LECs.[904] Finally, we tentatively concluded that it would be unwise to introduce a positive productivity adjustment,[905] instead of a productivity offset, to reflect plant modernization that has already occurred.

(2) Pleadings

420. A number of carriers and two states support this Commission's proposal to use existing tariffed rates as the basis for setting initial price cap levels.[906] AT&T argues that virtually all of its existing rates have been thoroughly scrutinized by this Commission and interested parties, including most recently this Commission's investigations of AT&T's rates effective January 1, 1988, and AT&T's private line rate structure.[907] Illinois and Ohio PUC state that existing rates are the most practical alternative.[908] Illinois asserts that the use of existing rates ensures that no customer will be worse off than under rate of return regulation.[909] The exchange carrier industry also argues that implementing a price cap system of regulation should include the use of existing rates. USTA and United, for example, argue that existing rates are within the zone of reasonableness.[910] SNET contends that the use of existing rates, which have been scrutinized and implemented in accordance with this Commission's tariff review requirements, is consistent with our obligation to ensure just, reasonable, and non-discriminatory rates.[911] Lincoln states that the Commission establishes a rate of return

---

(para. 257).

904 Further Notice, 3 FCC Rcd at 3337-38 (para. 259).

905 Id. at 3338 (para. 261).

906 See Bell Atlantic Comments at 9-10; Lincoln Comments at 4-5; Pactel Comments at 25-28; SWB Comments at 12-13; United Comments at 9-12; USTA Comments at 38; Illinois Comments at 24-25; Ohio PUC Comments at 10-11; GTOC Comments at v, 10-11; SNET Reply at 17.

907 AT&T Reply at 30.

908 Illinois Comments at 24-25; Ohio PUC Comments at 10-11.

909 Illinois Comments at 24-25. See also SNET Reply at 17.

910 United Comments at 9-10; USTA Comments at 38.

911 SNET Reply at 17.

for all carriers, and requires voluminous cost and demand data and quarterly monitoring reports.[912] Bell Atlantic and SWB assert that existing rates have survived the scrutiny of this Commission and interested parties, and that a rate represcription is therefore unnecessary.[913] GTOC argues that initiation of price caps does not require a previous adjustment of rates as the operation of the price cap formula and the CPD will protect consumers.[914] United, USTA, and SWB contend that this Commission's proposal preserves the ability of parties to seek suspension or rejection of rates they regard as unreasonable through the tariff review and complaint processes.[915] In addition, Pactel asserts that this Commission can establish procedures to permit carriers to adjust their rates should we subsequently conclude that rates for specific services must be modified.[916]

421. Several parties disagree that the tariff review procedures and complaint processes have been or will be sufficient to ensure that price cap rates will be just and reasonable. The Networks contend that the tariff review process is not stringent enough, and that the effectuation of reasonable rates should not be left to the complaint process. Instead, the Networks argue, users should be permitted to challenge price cap tariffs in accordance with the procedures by which they now challenge, for example, the annual access tariffs.[917] The Ohio PUC, while it agrees that existing rates should be employed, suggests that this Commission should resolve our pending investigations before price caps tariffs are adopted.[918] Other parties argue that this is unnecessary since, if any of AT&T's rates are subsequently found unlawful, this Commission has made it clear that we will order cap adjustments and refunds.[919]

422. Several parties contend that this Commission's tentative conclusions about incentives created by rate of return regulation necessarily

---

912 Lincoln Comments at 4-5.

913 Bell Atlantic Comments at 9-10; SWB Comments at 12-13.

914 GTOC Comments at 10-11.

915 SWB Comments at 12-13; United Comments at 9-12; USTA Comments at 38. See also Pactel Reply at 36.

916 Pactel Comments at 26.

917 Networks Comments at 9-18.

918 Ohio PUC Comments at 11. See also TCA Reply at 12.

919 AT&T Reply at 31-32; CBT Reply at 13-14.

imply that existing rates are too high.[920] API argues that many existing rates are not cost-based and are too high, while the Networks contend that, in particular, rates for television services are inflated.[921] CFA and Colorado OCC state that rates need to be adjusted because carriers, including AT&T, are overearning.[922] Connecticut OCC argues that existing errors in initial rates will be compounded under price caps, and DC PC and CFA contend that a price cap plan initiated with existing rates would yield unreasonable and discriminatory prices.[923] Indiana UCC argues that the starting point for a price cap program is critical because if the initial cap permits carriers to earn an unreasonable level of profits, or includes an inefficient level of costs, price cap levels will remain inflated indefinitely.[924] IDCMA states that AT&T has told its shareholders that a price cap regime would enable the company to achieve a 20 percent return on equity.[925] In its reply comments, NYNEX responds that assertions that rates are too high appear to imply that under rate of return regulation, a carrier may only recover expenses incurred if it can prove that it has been operating at maximum efficiency. NYNEX argues that this position is legally flawed and ignores the problems caused by rate of return regulation. NYNEX concludes that the Consumer Productivity Dividend and the improved efficiency structure of price cap regulation are the

---

920 Colorado OCC Comments at 14; Michigan PSC Comments at 17.

921 API Reply at 20; Networks Comments at 8-14. The Networks do not appear to limit their argument to LEC special access services.

922 CFA Comments at 17-18; Colorado OCC Comments at 28. The Oregon PUC states that as the Further Notice does not state AT&T's current earnings, the Oregon PUC has no assurance that rates would be reasonable under price cap regulation. Oregon PUC Reply at 10.

923 Connecticut OCC Comments at 9-10; CFA Reply at 5-6; DC PC Reply at 5-6. DC PC and Maryland PC argue that when AT&T was permitted price flexibility for its intrastate services in Maryland, it achieved annual profit levels of up to 125 percent. Maryland PC Comments at 10; DC PC Reply at 6. In its reply comments, AT&T argues that the argument is misleading because AT&T has a very small intrastate rate base compared to its revenue base so that small fluctuations in revenues or expenses can produce significant swings in returns on investment. AT&T Reply at 34 n.*.

924 Indiana UCC Comments at 9-14.

925 IDCMA Comments at 40-44. In its reply comments AT&T argues that a return on equity is different from (and generally higher than) the overall return on investment. In addition, AT&T states that this return on equity would be achieved in large part through earnings on the unregulated part of AT&T's business. AT&T Reply at 33 n.*.

best ways to counter inefficiencies that may have been caused by rate of return regulation.[926]

423. Consumer advocates, IDCMA, and two states assert that a rate case is necessary to ensure that initial price cap rates are reasonable.[927] However, several carriers and Illinois argue that a rate case is an administrative nightmare, and unnecessary.[928] As an alternative to a rate case, ICA and Indiana UCC propose that rates be reduced by a fixed percentage, perhaps 2-3 percent.[929] NTN concludes that, as (in its view) existing rates are unreasonable, and a rate case is administratively infeasible, this Commission should not proceed with price caps.[930] NTN and TCA also argue that the use of existing rates to initiate price caps provides carriers with an incentive to increase their rates in the time remaining before price caps are implemented.[931]

(3) Discussion

424. We believe that reliance on AT&T's existing rates is the most reasonable option for initially determining compliance with the price cap system. In reaching this determination, we have carefully considered the possibility that AT&T's existing rates lie outside the zone of reasonableness or, if within the zone for rate of return purposes, warrant "correction" prior to initiating a price cap regime. We have evaluated AT&T's existing earnings and the possibility that particular rates are unjust or unreasonable. We have also considered how the price cap mechanisms we adopt will influence rates in the future. For the reasons described below, we find that use of

---

926 NYNEX Reply at 15-16.

927 Colorado OCC Comments at 28; Indiana UCC Comments at 10-11, 28; IDCMA Comments at 42-44; New York DPS Comments at 27-28; Michigan PSC Comments at 17; DC PC Reply at 6.

928 Illinois Comments at 24-25; SWB Comments at 12-13; United Comments at 9; Pactel Comments at 25-28.

929 ICA Comments at 16-18; Indiana UCC Comments at 10-14. See also Michigan PSC Comments at 17 (advocating an automatic price cut). ICA's concerns appear to be directed primarily at the LECs in this instance. Lincoln opposes the "squeezing out" of inefficiencies, since no evidence has been offered establishing the size of any inefficiencies that may exist. Lincoln Comments at 4-5.

930 NTN Comments at 10.

931 Id. at 11; TCA Reply at 12.

AT&T's existing rates as a starting point will not operate to the detriment of ratepayers now or in the future, as some commenters argue. We also find that the use of existing rates as a starting point is the most expeditious means of generating the ratepayer benefits promised by incentive regulation, and is a superior alternative to conducting a pre-price cap rate case.

425. Some parties argue that existing rates are "too high," and therefore should not be used to initiate price caps.[932] If these parties mean that rates are "too high" in an economic sense, because they have been developed inefficiently, we agree. However, existing rates are not too high as a legal matter; if existing rates were not based on costs incurred in a rate of return environment, we would have required AT&T to lower them.[933] Moreover, AT&T underearned for the two year reporting period established in CC Docket No. 84-800. AT&T also underearned on an overall basis in 1988, and earned less than its allowable rate of return or within the return allowed by CC Docket No. 84-800 in both its public switched and private line categories for that period.[934] Thus, for each of these aggregate service categories, AT&T's rates appear to be within the zone of reasonableness. The fact that AT&T's reported rate of return is below the legal limit strongly

---

932 In some cases, this contention appears to be based on erroneous assumptions. For example, CFA and Colorado OCC assert that AT&T is overearning, which is not the case.

933 See Section II.A, supra.

934 See AT&T's Interstate Rate of Return Report, Form 492, filed March 31, 1989. AT&T's actual rate of return has not exceeded its authorized rate of return in any year since divestiture. From 1984 to 1986, AT&T's authorized rate of return was 12.75 percent. See Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Report and Order, FCC 85-327, released Sept. 30, 1985 at para. 4. AT&T earned 10.2 percent in 1984, 11.84 percent in 1985, and 11.31 percent in 1986. See AT&T Interstate Monthly Reports for December 1984, December 1985, and December 1986. Since January, 1987, AT&T's authorized rate of return has been 12.2 percent. Authorized Rate of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Memorandum Opinion and Order, 51 Fed. Reg. 32,920 (Sept. 17, 1986). For 1987, AT&T earned 8.61 percent in the public switched category, and 8.67 percent in the private line category. See AT&T's Interstate Rate of Return Report, Form 492, filed March 31, 1988. For 1988, AT&T earned 12.24 percent on its public switched services, and 10.08 percent on its private line services. Its cumulative earnings over the two year 1987-1988 period were 10.03 percent for public switched services and 10 percent for private line services. See AT&T's Interstate Rate of Return Report (Form 492), filed March 31, 1989.

suggests that AT&T's rates are not too high, given the costs attributed to the service categories. As to individual rates, the Common Carrier Bureau has recently concluded investigations of nearly all of AT&T's existing rates, including a full scale investigation of AT&T's rates effective January 1, 1988, and AT&T's private line rate structure.[935] We have also recently completed an investigation of AT&T's 56 kbps switched digital services.[936] We determined that these rates are not unlawful. We also note that many of AT&T's existing rates were set in the context of competitive pressures from other carriers, which contributes to the reasonableness of using them as a starting point for price cap regulation.[937]

426. We do not believe that it is advisable to adjust existing rates before initiating price cap regulation. Some parties would have us require a rate case before initation of price caps, thereby implicitly requesting assurance that every service earns precisely the authorized rate of return. We do not believe that a rate case, however streamlined or truncated, would serve the public interest. As an initial matter, since AT&T is presently underearning in the aggregate, a rate case would logically result in an increase in aggregate rates, despite AT&T's willingness to employ existing

---

935 AT&T Communications, Revision to Tariff F.C.C. Nos. 1, 2, 11, 13, and 14, 3 FCC Rcd 3617 (1988); AT&T Communications, Revisions to Tariff F.C.C. Nos. 1, 2, 11, 13 and 14, Transmittal Nos. 1063 and 1064, CC Docket No. 87-611, Memorandum Opinion and Order, DA 88-1707 (released Nov. 1, 1988); AT&T Communications Tariff F.C.C. Nos. 9, 10, and 11, Transmittal Nos. 285, 318, 342, 346, 504, and 559, CC Docket No. 85-400, 3 FCC Rcd 4579 (1988).

936 AT&T Communications, Tariff F.C.C. Nos. 4 and 10, Transmittal No. 311, Memorandum Opinion and Order, 3 FCC Rcd 5929 (1988).

937 To the extent that parties arguing that existing rates are too high in the economic sense contend that the initiation of price caps with existing rates will permit AT&T a windfall, we disagree. This argument assumes that AT&T can reduce its costs instantaneously and recoup the difference between regulatory and economic costs. While we expect that price cap regulation will provided incentives to be more efficient, we do not expect these efficiencies to be realized immediately on a flash-cut basis, but rather, to accumulate over a span of years. It is apparent that AT&T will not be able to reduce its rate base immediately, and it may also take some time before AT&T has significantly reduced its expenses. There is a recognition in the economic literature that impediments to adjustment of expenses exist and take some time to overcome. See, e.g., Scherer, Industrial Market Structure and Economic Performance 31-32 (1980); K. Cohen and R. Cyert, Theory of the Firm 334 (1965).

rates as a starting position.[938] The additional flexibility provided by a higher set of rates would appear to run counter to the objectives of the critics of existing rates.[939] Furthermore, a rate case demands that regulators employ a cost allocation methodology so that joint and common costs incurred in the provision of common carrier service are reflected in some systematic way in the measurement of service costs. But cost allocation standards imposed by regulators, such as the fully distributed costing methodology we have employed in such situations, will simply produce a set of rates that is dictated by the costing methodology employed.[940] Thus, the rates that we would derive in the course of a rate case would not necessarily be driven by economic efficiency; they would more likely reflect a cost allocation decision imposed by regulators.

427. A rate case, in our judgment, would be an administratively burdensome, and possibly time consuming process, with no guarantee of results that are substantially different from (let alone lower than) existing rates. As an alternative to a rate case, ICA and Indiana propose that rates be reduced by a fixed percentage in order to squeeze out unnecessary investment and expenses occurring under rate of return regulation. We tentatively proposed in the alternative that such a mechanism be applied to LEC rates, but not to AT&T rates.[941] Commenters have not substantiated their assertions that such an adjustment should be applied to AT&T and we do not adopt that proposal.

428. As we discussed in Section II of this Order, one weakness of rate of return regulation is that it permits rates to be too high in an economic sense, but reasonable in a legal sense. It is in part for this reason that we have decided to alter the regulatory system, and impose an incentive structure. In contrast to conducting a pre-price cap rate case, the initiation of price caps using AT&T's existing rates immediately introduces the type of efficiency incentives that result in the lowering of carrier costs. At the same time, AT&T will be provided with a limited amount of pricing flexibility that will enable it to begin to gravitate toward a set of more economically efficient prices. In short, the decision to employ

---

938 AT&T Reply at 29-32.

939 See Colorado OCC Comments at 14; API Reply at 20.

940 See generally Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298, 1317-18 (paras. 147-153); see also MCI Telecommunications Corp. v. FCC, 675 F.2d 408, 415-16 (D.C.Cir. 1982).

941 Further Notice, 3 FCC Rcd at 3337-38 (para. 259).

existing rates means that without substantial delay, significant benefits can immediately begin to accrue to consumers of AT&T services.

429. It is also important to consider the context in which existing rates will be used and how our price cap system will influence rates over the course of time. Our redefinition of AT&T's baskets ensures that services subject to less competition are isolated from those subject to more competition. As a result, AT&T is sharply constrained in its ability to employ its newly established pricing flexibility for anticompetitive purposes. The growing competition that exists for many of AT&T services will also serve to encourage competitive pricing, since large margins on services will only invite additional entry. The operation of the PCI formula itself exerts downward pressure on the aggregate prices in each basket through the operation of the productivity factor and, specifically, the Consumer Productivity Dividend. The initialization of the PCI at 100 for the base year has the effect (all other things being equal) of reducing existing rates by 3 percent in real terms at the time of the first price cap filing. The CPD results in a productivity adjustment that is higher than the historical productivity of the telephone industry, and will prevent AT&T from benefiting from past inefficiencies.[942] In addition, parties will continue to have the opportunity in both the tariff review and complaint processes to challenge rates they consider unjust or unreasonable. This Commission will independently examine rate levels through monitoring and our performance review that are an integral part of the initial stages of price cap regulation. We believe that these factors, taken together, assure that existing rates, filtered through our price cap formulas and procedural mechanisms, will produce price cap rates that will be within the zone of reasonableness.[943]

430. We agree with those parties that assert that pending investigations should be resolved as soon as possible. We are proceeding with those

---

942 In Section III.C.1.c, supra, we address arguments concerning the size of the CPD and how it should be recovered from carriers under a price cap system.

943 The Networks propose that interested parties should be permitted to challenge the price cap tariff in the same way that they can challenge the annual access tariff. This proposal conflicts with our decision to afford streamlined treatment to below-cap filings, and is addressed in Section III.C.4, infra.

investigations expeditiously.[944] The existence of unresolved investigations, however, need not, and should not, delay the implementation of price caps. Should we find, at the conclusion of one of these pending investigations, or any new investigation commenced on this Commission's own initiative or at the request of an interested party, that an existing rate is unlawful, we will order refunds or make adjustments to the PCI or API, or both.[945]

ii. Start-up Issues

(1) Summary of Further Notice

431. In the Further Notice, this Commission tentatively concluded that AT&T's PCIs and BPIs should be initialized at a value of 100 for each basket for the base period preceding the inaugural price cap filing.[946] We proposed an April 1, 1989, effective date for the initial price cap tariffs, and an initial base period running from October 1, 1987, through September 30, 1988.[947] Thus, under our proposal in the Further Notice, at the outset of price caps AT&T would file adjustments to its PCIs to reflect the difference between the costs for the period covered by the first price cap tariff and the average costs incurred during the pre-cap base period.[948] Likewise, the Further Notice required that AT&T's initial rates under price caps be reflected in API values that resulted from comparing the proposed initial

---

944 See AT&T Communications, CC Docket No. 85-326 and Transmittal Nos. 434 and 435, Memorandum Opinion and Order, FCC 85-584, released November 7, 1985 (Megacom and Megacom 800); AT&T Revisions to Tariff F.C.C. No. 259, Wide Area Telecommunications Service (WATS), CC Docket No. 80-765, Memorandum Opinion and Order, 84 FCC 2d 158 (1980); AT&T Communications, Revisions to Tariff F.C.C. Nos. 1,9, and 10, CC Docket No. 85-203, 103 FCC 2d 157 (1985) (SDN).

945 Pactel argues that the Commission could establish procedures to permit carriers to adjust rates if necessary. We believe that the necessary procedures are in place. See Section III.C.3.b, supra.

946 Further Notice, 3 FCC Rcd at 3436, 3439 (paras. 447, 453).

947 See id. at 3515, 3519-20 (proposed Sections 61.3(f) and 61.43 of this Commission's Rules).

948 Id. at 3426 (para. 447).

rates with the average rates (represented by the initial BPI values of 100) in effect during the pre-cap base period.[949] We required that the initial APIs, so calculated, not exceed the corresponding PCIs, as adjusted in the initial price cap filing.

(2) Pleadings

432. A number of commenters raise specific technical concerns regarding the manner in which the Further Notice proposed to apply cost and price data from the pre-price cap period in initializing AT&T's PCIs and APIs.[950] Most parties commenting on the issue oppose including the last quarter of 1987 in the initial pre-cap base period.[951] They argue, in essence, that since costs and rates changed between the 1987 and 1988 tariff years, using a blended average of those costs and rates, rather than 1988 data, as the points of reference for calculating initial API and PCI levels may not produce an accurate reflection of the relationship between rates and costs at the outset of price caps.[952]

433. Commenters propose various solutions to the perceived problem of initiating price caps based upon data from two rate of return tariff years. Some propose that we adopt as initial base period benchmark rates the average rates in effect from January 1, 1988, through September 30, 1988, at annualized demand.[953] Others propose that we use for that purpose the rates in effect on September 30, 1988, weighted according to demand during the period from October 1, 1987, through September 30, 1988.[954] Still others suggest that we use September 30, 1988, rates, weighted according to demand

---

949 Id. at 3438-39 (paras. 451 and 453).

950 These concerns are apart from the general methodological issues discussed above in connection with the selection of our API and PCI formulas (see Sections III.C.1.e, and III.C.3.a, supra), and apart from the general policy issues we have discussed regarding the reasonableness of employing rate of return generated rates as a point of departure for price caps (see Section III.C.3.d.i, supra).

951 See, e.g., SWB Comments at 14-16; GTOC Comments at 25-27, 38-39; NYNEX Comments at 40-45; Centel Comments at 23-27. But see Pactel Comments at 25-26 (supporting use of rates from October 1, 1987, through September 30, 1988, in initiating price caps).

952 See generally id.

953 E.g., Centel Comments at 10.

954 See, e.g., CBT Comments at 16-17.

during the period from January 1, 1988, through September 30, 1988.[955] Several commenters urge this Commission to use rates and weights from 1988, adjusted to meet the prescribed rate of return.[956] AT&T and Ameritech urge this Commission to initialize the APIs and PCIs based upon prices and costs in effect the day before price caps become effective.[957]

434. Several commenters raise a different technical concern regarding the initiation of price cap regulation. They contend that the (GNP-PI - X) component of the PCI formula must be adjusted during the first tariff year under price caps to account for the fact that the "year" will be 15 months long. These parties note that that component of the formula reflects annualized cost and productivity changes, and should be adjusted to account for the longer period covered by the initial price cap tariffs.[958] Beyond this adjustment to account for the 15-month tariff year, these parties also propose compounding the base period rates of inflation and productivity change to account for the lag between the base period and the tariff year.[959] Two commenters contend that the second base period under price caps should exclude the period from October 1, 1988, through March 31, 1989, so that only data generated under price cap regulation will be used in the second base period.[960]

(3) Discussion

435. Our decision to modify the API and PCI formulas and to delay price caps for AT&T from April 1, 1989, until July 1, 1989, moots many of the issues raised in the pleadings. For example, the adoption of APIs and PCIs that compare point-in-time prices and costs eliminates the need to calculate base period average costs and prices in establishing initial index values. Moreover, our decision to inaugurate price caps July 1, 1989, establishes an initial base period (the 12-month period ending six months prior to the effective date of the annual price cap tariff) of January 1, 1988 through December 31, 1988. Since calendar year 1988 falls within one annual tariff

---

955 E.g., Bell Atlantic Comments at 10 n.20; USTA Reply at 22-23.

956 E.g., NYNEX Comments at 40-45; Colorado OCC Comments at 28. Cf. SWB Reply at 41-42; USTA Reply at 22-23 (having no objection to starting price caps with rates retargeted to the prescribed rate of return).

957 AT&T Comments at 36; Ameritech Comments at 11-14.

958 GTOC Comments at 39; SWB Comments at 15-16; Pactel Comments at 41-43.

959 Id.

960 NYNEX Comments at 40-45; GTOC Comments at 27.

year, this schedule eliminates the problem perceived by some commenters of initiating price caps using a base period that blends data from two rate of return tariff years.

436. The issue remains, however, of which pre-price cap point-in-time costs and prices to use as benchmarks in calculating the API and PCI levels that will be in effect on July 1, 1989. We believe the most reasonable manner of initializing AT&T's pre-price cap APIs and PCIs is to assign to those indexes a value of 100, corresponding to the levels of rates and costs in effect on December 31, 1988, the last day of the base period for the inaugural price cap filing.[961] Having thus established in the indexes an alignment of rates and costs as of December 31, 1988, the APIs and PCIs would then be adjusted in connection with the initial price cap tariff filing to reflect changes in rates and costs that occur between that time and July 1, 1990.

437. While more current rate and cost levels, for example those in effect the day before the initial price cap tariffs become effective, might ordinarily be expected to reflect more accurately the relationship between AT&T's rates and costs immediately prior to the inaugural date, we believe it is preferable to align AT&T's APIs and PCIs as of a date that has already passed in order to avoid the possibility of attempted pricing revisions in anticipation of price caps. Moreover, we conclude that December 31, 1988, rates provide a reasonable starting point for aligning the indexes, since, as noted in Section III.C.3.d.i, supra, most of AT&T's 1988 rates have been investigated and found not to be unlawful.

438. Since under the revised price cap schedule we are adopting, AT&T's initial price cap tariff year will be 12, rather than 15, months long, we find it unnecessary to make any special adjustment to the PCI's inflation and productivity variables (GNP-PI - X) in connection with the initial filing. We also reject the notion that the (GNP-PI - X) variable should be compounded on an ongoing basis to reflect the six-month lag between the base period and the tariff year. Under price cap regulation, the purpose of the (GNP-PI - X) variable in the PCI formula is simply to forecast inflation and productivity changes during the upcoming year. It is not designed to reflect past cost changes for which carriers must be compensated.

---

961 We also direct that AT&T's SBIs be initialized at a value of 100 as of December 31, 1988. The applicable banding limitations on AT&T's service category rates during the first price cap tariff year would be enforced with reference to the changes in SBI levels from June 30, 1989, through June 30, 1990.

4. Evaluation of Price Cap Rates

439. In the Further Notice we proposed tariff filing and review procedures designed to afford AT&T significant rate flexibility while preserving opportunities for review by this Commission and interested parties that will ensure that rates remain within the zone of reasonableness. We tentatively found that administration of a price cap system of regulation required an annual price cap filing in addition to routine filings to change rate levels. We proposed streamlined treatment for all tariff filings, other than the annual filing, that proposed rate level changes that neither raised the API above the PCI nor violated the banding restrictions. We did not propose to streamline above-band, below-band, and above-cap filings, nor proposed tariffs for new or restructured services. The procedures and standards for review which we proposed for each of these types of filings are described and discussed separately below.

a. Annual Filings

i. Summary of Further Notice

440. We proposed to require AT&T to make an annual price cap tariff filing demonstrating that it had correctly adjusted its price cap index for each basket, that the actual price index for each basket did not exceed the relevant price cap index, and that all rates were within applicable price bands. We further proposed to allow AT&T to amend rate levels in the annual filing, but to require them to do so only if rate changes were necessary to achieve compliance with the price cap or the price bands. We proposed that AT&T file its first annual price cap tariff on February 16, 1989, with an effective date of April 1, 1989.[962] Thereafter, AT&T's annual price cap tariffs would be filed on 45 days' notice with an effective date of July 1 of each year.

ii. Pleadings

441. Few parties address the proposed procedures for AT&T's annual filing. Centel suggests that, to facilitate monitoring of prices under price regulation, each rate filing should include a comparison of new rates with then-existing rates.[963]

---

962 Our proposal would have required LECs to file initial price cap tariffs December 30, 1988, with effective dates of April 1, 1989. AT&T's filing dates were selected in order to allow AT&T time to incorporate access charge changes into their initial price cap filing.

963 Centel Comments at 14.

iii. Discussion

442. We adopt our proposal to require AT&T to make annual price cap filings demonstrating compliance with the price cap rules. Those filings will be made on 45 days' notice and will be due 45 days after the date on which LECs file their annual access tariffs. The first annual AT&T filing is due on May 17, 1989, to become effective July 1, 1989. The following year, and in each year thereafter, the effective date of the AT&T price cap filing will be July 1. This schedule of annual filings assures that AT&T will have adequate time to incorporate access charge changes into its rates, and that AT&T's rates will take effect at the same time as those access charge changes.[964]

443. Consistent with our practices for our annual access tariff review, we will restrict the annual price cap filing to changes in rate levels and to the incorporation of previously-introduced "new" services into the cap. See 47 CFR § 69.3(a). As we determined in connection with our access charge system, bifurcation of rate restructuring and rate level changes will contribute to the orderly review of AT&T's annual filing. However, in making this distinction between rate level changes and restructuring, it is not our intent to preclude AT&T from proposing any changes in discounts or tapers in its annual filings. To the extent that such changes -- while necessitating some minor modifications to tariff language -- are essentially rate level changes and do not require recalculation of estimated base period demand in the API and SBI calculations, we will permit them in connection with the annual filing. In addition, we anticipate that most of AT&T's rates will generally be maintained within the no-suspension zone we have established, but we do not preclude AT&T from filing above-band or above-cap rates in its annual filing.

444. The annual price cap tariff filings will include the information set forth in new Section 61.43 of our Rules.[965] We agree with Centel that it might be useful to be able readily to compare existing with proposed rates. We therefore require AT&T to include in its annual filing a complete rate comparison schedule.

---

964 In considering comments on the treatment of access charge changes as an exogenous cost, we have rejected a suggestion to require quarterly filings incorporating those changes. See Section III.C.1.d., supra.

965 See Appendix B.

b. Within-Band Rate Level Changes

i. Summary of Further Notice

445. In the Further Notice we proposed to streamline our treatment of rate level changes, so long as the change produced an actual price index that was less than or equal to the price cap index, and the rates fell within the applicable price bands. Specifically, we proposed that tariff revisions making such rate level changes would be filed on 14 days' notice and that they would be presumed lawful for tariff review purposes. In lieu of traditional cost support, streamlined filings would need to be supported only by the calculations necessary to demonstrate that the proposed rates were within the limits set by the PCI and the price bands.

446. We tentatively found that the presumption of lawfulness which would attach to below-cap/within-band rates should be embodied in a rule establishing a stringent four-part test applicable to petitions seeking suspension of streamlined filing. The proposed test, which was similar to that applied by courts to requests for preliminary injunctions,[966] required the petitioner to demonstrate (1) a high probability that the tariff would be found unlawful after investigation; (2) that suspension would not substantially harm other interested parties; (3) that irreparable injury would result if suspension did not issue; and (4) that suspension would not otherwise be contrary to the public interest. We stated that use of this test to establish a "no-suspension zone"[967] was warranted because within cap rates could be presumed for tariff review purposes to fall within the zone of reasonableness. We also found we had the legal authority to administer such a "no-suspension zone."[968]

ii. Pleadings

447. Carriers strongly support the streamlined procedures for within-cap/within-band rates, their only complaint being that we do not propose broader availability of streamlined procedures.[969]

---

966 E.g., Virginia Petroleum Jobbers Ass'n v. FPC, 259 F.2d 921 (D.C. Cir. 1958).

967 See Section V, infra.

968 Further Notice at 3300 (para. 197).

969 See, e.g., AT&T Comments at 23-35; AT&T Reply at 52-53.

448. Some users, competitors, and state regulators view the streamlining proposal, and particularly the showing for suspension of a presumptively lawful rate, as unfairly assymetrical in its distribution of risks and burdens between carriers and petitioners. Ad Hoc illustrates this concern by positing two opposite scenarios in which the price cap formulas produce unjust or unreasonable rates. In Ad Hoc's first scenario, the cap permits carriers to file unlawfully high rates. Because these rates are nevertheless presumed lawful, aggrieved ratepayers must either make an extraordinarily stringent showing for suspension[970] or resort to "time-consuming, expensive, risky complaint procedures."[971] In the opposite scenario, in which price caps produces confiscatorily low rates, Ad Hoc contends that carriers would have a "real opportunity to protect themselves" by filing above-cap rates subject to a likelihood of suspension but no heightened substantive showing beyond that which is required today.[972]

449. Several parties who support Ad Hoc's position focus particularly on the unavailablilty of cost support data to petitioners. ICA, for example, submits a study which states, inter alia, that "consumers might have difficulty proving, or establishing a high probability of, discrimination or anti-competitive effect in the absence of cost allocation data, since the appropriateness of rate differentials is at least partly dependent on cost differentials."[973] NARUC finds it doubtful that one who finds cause to question the reasonableness of a rate will have an adequate basis of information on which to base a case,[974] while ALC asserts that presumptively lawful rates which were priced below cost could never be proven unlawful.[975]

450. API opposes the test on the grounds that it would be nearly impossible for large users to demonstrate irreparable injury in connection with a petition to suspend and investigate a tariff. According to API, a petitioner challenging a below-cap/within-band rate increase should be able

---

970 Ad Hoc characterizes the showing as more demanding than that used for filings subject to streamlining under Competitive Carrier, and notes that no tariff filing subject to the competitive carrier rules has ever been suspended or rejected on substantive grounds. Ad Hoc Comments at 14.

971 Id. (footnote omitted).

972 Id. at 15.

973 ICA Comments, Att. B, at 77.

974 NARUC Reply at 14-15.

975 ALC Comments at 10.

to obtain suspension upon a showing of a high probability of unlawfulness. API argues that its preferred standard presents an extremely difficult burden to meet and would not promote frivolous tariff protests, but simply "balance the scales in an equitable manner".[976]

451. Maryland PC argues that the proposal is not only unfair, but that the presumption of lawfulness, the four-part test for suspension, and the omission of cost support, when taken together, constitute an unlawful shifting of the burden of proof in proceedings under Section 204(a) of the Act. They contend that, while this Commission concededly has discretion in determining whether to initiate a rate investigation, the combined effect of the proposed rules will insulate our decisionmaking to a degree not intended by Congress.[977] AARP also argues that the streamlined procedures improperly shift statutory burdens of proof.[978]

452. GTOC and SWB, characterizing the contentions of Maryland PC and AARP as "false"[979] and "astonishing",[980] argue that our proposal has no impact on any statutory burden of proof. GTOC notes that Section 204(a) simply indicates that, in a hearing involving a rate increase, the burden is on the carrier to show that the proposed increase is just and reasonable.[981] SWB suggests that it is important, in analyzing burden of proof issues, to remember that the price cap rules only establish a "no-suspension zone" and not a "no-investigation zone," and that there is nothing in the Further Notice which would inhibit investigations or shift burdens of proof in an investigation.[982]

iii. Discussion

453. We conclude that our proposed tariff filing procedures for below-cap/within-band rates are consistent with Section 204(a) of the Communications Act. We further conclude that those procedures reasonably reflect the equitable balance between ratepayer and shareholder interests

---

976 API Comments at 26-27.

977 Maryland PC Comments at 18-19.

978 AARP Comments at 34-38.

979 SWB Reply at 39.

980 GTOC Reply at 12.

981 Id. at 13-14.

982 SWB Reply at 40.

that is established by the Act and by the substantive elements of our incentive regulation program for AT&T. We therefore adopt the tariff filing procedures contained in Sections 61.49(a) & (b) and 1.773(a)(1)(iv) of this Commission's Rules, as they appear in Appendix B of this Order.

454. The position taken by Maryland PC and AARP that our streamlined procedures illegally shift the burden of proof in proceedings under Section 204(a) of the Communications Act is simply incorrect. Section 204(a) states, in relevant part, that "[a]t any hearing involving a charge increased, or sought to be increased, the burden of proof to show that the increased charge, or proposed charge, is just and reasonable shall be upon the carrier... ."[983] On its face it is clear that this statutory burden of proof attaches only at the point when we designate a proposed rate increase for investigation.[984] The only way our presumption of lawfulness could violate Section 204(a), then, would be if we applied that presumption to a tariff filing under investigation.

455. Manifestly, the rules we are adopting do not employ the presumption of lawfulness, nor the extraordinary showing which defines the limits of that presumption, in such a manner. On the contrary, the presumption of lawfulness applies only to the determination whether a rate should be suspended. If we designate a tariff filing for investigation, and regardless of whether the tariff has gone into effect, the carrier has the burden to justify the justness and reasonableness of the rates at issue.

456. We reject the contention that our streamlining procedures are unfair to ratepayers because the suspension showing is more demanding than the showing required to justify an above-cap filing. First, while it is true that we are making it difficult to justify suspension of a below-cap tariff that satisfies our upper band limits, Ad Hoc and others seriously underestimate the difficulty of the showing we are requiring for above-cap filings.[985] Second, to be fair, the burdens which the parties would have us compare need not be symmetrical. Rather, the separate burdens on ratepayers and on carriers should each be commensurate with the risk to each group that a below-cap rate will be unreasonable. As discussed in Section

---

983 47 U.S.C. § 204(a).

984 A tariff investigation constitutes a hearing within the meaning of Section 204(a). We do not imply, of course, that Section 204(a) states the only situation in which carriers have the burden of proof with respect to the justness and reasonableness of their rates. We have long held that, in a hearing, carriers bear the burden of proof on other issues of lawfulness as well. See, e.g., Private Line Rate Case, 34 FCC 217, 317 (1961).

985 See Section III.C.4.d., infra.

III.C.3.d.i, supra, it is extremely unlikely, but possible, that rates which are based on existing AT&T rates, which are constrained by our price cap formula, including the productivity adjustment and the CPD, and which are further restrained by competition, could be unreasonably high. Under these circumstances, suspension should also be extremely unlikely, but possible. We find that the standard we have adopted accomplishes that degree of likelihood of suspension and is, therefore, fair to ratepayers.[986]

457. We disagree with the parties who contend that we have established a standard that is impossible to meet, and that we should remedy this by eliminating the requirement of a showing of "irreparable harm." It is true that "irreparable harm," in the context of a prayer for preliminary injunctive relief, usually means that the party seeking the injunction must be facing an injury which is not compensable through money damages. It might seem, therefore, that suspension could never be granted for allegedly high rates, since a ratepayer would face only the loss of money. We do not, however, intend to adopt uncritically all of the case law defining the injunction standard as part and parcel of our own standard. In the case of telecommunications rates, there may well be instances in which the logistics of ordering a refund, or other factors, could constitute "irreparable harm." We also acknowledge that a large user will probably find it especially difficult to make a credible argument that it would be irreparably harmed by a rate increase. On the other hand, competition is most intense for the business of these large users, so that they are the least likely of all customers to be faced with unjustified rate increases.

458. We also reject the contention that the streamlined procedures are unfair because consumers will not have access to cost information which the carriers, of course, possess. The parties who focus on this issue seem to believe that we will refuse to investigate, as well as refuse to suspend, if the petitioner cannot make the showing set forth in our new Section 1.773(a)(1). This belief is unjustified. Furthermore, as we stated in the Further Notice, we do not expect parties to produce evidence to which they have no access.[987] Persuasive evidence of, for example, several rate increases in succession for a particular service, discriminatorily high increases for certain services, or precipitous decreases having anticompetitive effect, would likely warrant requiring the carrier to come forward with additional rate information. Of course, to the extent that the parties' concern is simply that they will no longer be able to challenge rates

---

986 The relationship between the risk to AT&T that a below-cap rate will be unreasonably low, and the burdensomeness of the required showing for an above-cap filing, is discussed below.

987 Further Notice, 3 FCC Rcd at 3303 (para. 202) (citing Advanced Micro Devices, 742 F.2d 1520 at 1536.)

on the grounds that AT&T is earning more than a prescribed rate of return, their complaints go, not to the procedures at issue here, but to the very concept of incentive regulation. These matters are addressed at the beginning of this Order.[988] We note, however, that AT&T's rates will still be subject to challenge in the complaint process and, to the extent discussed herein, in the tariff review process, on the basis that they result in excessive profits.

c. Above-band rates

i. Summary of Further Notice

459. In the Further Notice we tentatively found that proposed rate increases which exceeded our banding limitations, but which did not drive the actual price index above the price cap index, raised issues of rate increase burdens and rate churn. Accordingly, we proposed to require tariffs proposing above-band rate increases to be filed on 90 days' notice, with a high probability of suspension. We further proposed to permit such tariffs to take effect only upon a showing of substantial cause.[989]

ii. Pleadings

460. AT&T and Cincinnati Bell find the 90 days' notice requirement to be excessive. Noting that many of its tariffs currently go into effect in 45 days, AT&T suggests that it would suffice to require 45 days notice for above-band filings. AT&T points out that we could then extend the period to 90 days where needed, while avoiding unnecessary delay in cases where issues are resolvable in 45 days.[990] Michigan, on the other hand, contends that 90 days may not be long enough to allow interested persons to respond to rate proposals. Michigan advocates establishing time frames of between 90 days and a year, depending on the magnitude of the filings.[991]

461. Some parties accept our proposed use of the substantial cause test, albeit in terms of their own interpretations of the test. NTN, for example, agrees that AT&T should be required to meet this "heavy burden" in order to

---

988 See generally Section II, supra.

989 See RCA American Communications, 86 FCC 2d 1197 (1981)(applying substantial cause test to attempt by carrier to change the terms of a long term tariff in a manner detrimental to ratepayers' interests); RCA American Communications, 2 FCC Rcd 2363 (1987)(applying substantial cause test to proposed change in rates for fixed term service).

990 AT&T Comments at 28-30.

991 Michigan PSC Comments at 21-22.

justify an above-band increase, but asserts that the primary emphasis of the test should not be fulfilling ratepayers' reasonable expectations under a price cap regime, but rather preventing AT&T from "supplementing its already broad powers to cross-subsidize."[992] TCA urges us to state that "substantial cause" will be found only if a carrier faces substantial, truly unforeseeable costs, and that increases unrelated to cost, or based on inaccurate estimates, will not be allowed.[993] AT&T agrees that customers would reasonably expect that prices would not routinely be raised above the bands, and that such increases should be fully supported and carefully reviewed; they argue, however, that the substantial cause test would be inappropriate for use with rate element banding. Ameritech argues, without taking issue with the test itself, that the data required to meet the test should vary with the reason advanced by the carrier.[994]

462. Some parties object to the test as vague and undefined. DC PSC, in explaining why it is concerned about the amount of flexibility that carriers would have under price caps, complains that the substantial cause test could result in ad hoc standards being developed during later challenges.[995] NARUC states that the meaning of "unforeseeable circumstances" remains doubtful after the RCA American Communications cases, as does the applicability of the foreseeablility standard to price caps.[996] MCI finds it "surprising and disturbing" that tariff review standard issues have been so inadequately developed as to prompt such objections. MCI cautions that the issues, consumer interests, and competitive concerns and dollars involved are too important to have the Commission and interested parties "wing it" once the new regime is in place.[997]

463. Other parties deem the test to be narrowly defined by the RCA American Communications cases and therefore inapplicable to its proposed use under price caps. Cable & Wireless argues that the substantial cause test offers no security for consumers because it has been applied exclusively

---

992 NTN Comments at 21-22.

993 TCA Comments at 10; TCA Reply at 20.

994 Ameritech Comments at 8-9. Ameritech asserts that there are two justifications for above-band rates: (1) the increase is necessary to cover the cost of providing service, or (2) the adjustment is necessary in light of adjustments to other rates to maintain rate relationships.

995 DC PSC Comments at 17.

996 NARUC Reply at 13-14.

997 MCI Reply at 25-26.

in the context of the contract-like relationship established between carrier and specific customer under long term tariffs. Cable & Wireless notes that this Commission has stated the two principal factors to be looked at under the substantial cause test as 1) the carrier's explanation of the reasons for the proposed change and 2) the position of the customer in relying on the long term agreement. According to Cable & Wireless, the absence of a specific customer or small set of discrete customers whose reliance on existing rates can be examined renders the second half of the test irrational with respect to a proposed increase in rates for a service such as basic MTS.[998] Furthermore, it claims, since the first half of the test has generally involved inquiry into issues such as the cost of capital and general increases in costs, use of the test will simply permit a carrier to file for a rate case whenever it finds the price cap inconvenient.[999]

464. Comptel and United draw competing conclusions from their shared belief that the substantial cause test is limited by facts of the cases in which it has previously been applied. Comptel argues that, because we have never applied the substantial cause test to changes in conventional monthly service rates, and because we lack any objective cost or other information by which to guage the carrier's explanations of its proposed increases, a carrier's explanation would carry a presumption of validity that would be very difficult to rebut.[1000] Coming from the opposite point of view, United objects to using a test developed for the special situation of a long term contract-like tariff on the grounds that such a test would tend to fix rates in a narrow band without any concomitant commitment by customers.[1001] United also questions the lawfulness of the test, citing a Circuit Court remand of the case in which we first applied the standard.[1002]

465. ALC sees the test as too weak because it allows the carrier to make an explanation without providing any cost support or other objective data. Cable & Wireless, by contrast, sees the test as calling for a full-blown rate case; they advocate that we eschew this approach and prescribe the bands

---

998 Cable & Wireless Comments at 32.

999 Cable & Wireless offers this argument in support of its contention that we must prescribe the price cap and the bands in order to provide sufficient rate stability to justify doing away with the benefits of rate of return regulation. Id. at 33; Cable & Wireless Reply at 12.

1000 Comptel Comments at 26-27.

1001 United Comments at 14.

1002 Id. United cites RCA American Communications, Inc., v. FCC, 684 F.2d 1033 (D.C. Cir. 1982).

instead. New York DPS agrees that we should simply forbid above-band rates for the first four years of price caps.[1003]

iii. Discussion

466. We affirm our tentative conclusion that above-band rates raise questions about the distribution of rate increase burdens that require the fullest possible consideration by interested parties and by this Commission. We therefore adopt our proposal to require such rates to be filed on 90 days' notice, with a likelihood of suspension. We further find that the justness and reasonableness of above-band rates must be assessed in light of the overall price caps scheme, and that the "substantial cause" test is an acceptable vehicle for such an assessment.

467. We disagree with AT&T's contention that 45 days will usually provide enough time to determine the reasonableness of an above-band filing. The price bands are intended as a constraint on cost-shifting and as a protection against large rate increases in a short period of time. The "substantial cause" showing will usually involve a detailed and specific cost justification of the proposed increase. Interested parties will need the time provided by the 90-day notice period to evaluate and respond to such filings, as will this Commission.

468. We are not oblivious to the concern expressed by Michigan PSC about the potential volume and complexity of an above-band filing. However, we are prohibited by Section 203(b)(2) of the Communications Act[1004] from adopting Michigan PSC's suggestion that we establish notice periods longer than 90 days. As we stated in the Further Notice, it is likely that above-band filings will be suspended in order to allow for full examination of AT&T's showings.

469. A brief review of the RCA American Communications cases will bring into proper perspective the arguments of those parties who contend that the substantial cause test is either too vague or too well-defined to be used in the instant context.

470. In 1978, RCA American Communications filed a tariff under which customers could take satellite transponder service for various fixed periods of time. Some customers opted for 10-year terms. In 1980, the carrier filed a tariff in which it sought both to restructure the offering so as to shorten the terms of service, and to raise its rates. We suspended this filing and

---

1003 Claims that we should, or must, use our power under Section 205 of the Communications Act to prescribe initial rates, bands, or other elements of our proposal are addressed at Section V, infra.

1004 47 U.S.C. § 203(b)(2).

ordered an investigation into the proposed restructuring. The threshold issue in that investigation was the proper standard which should be used to evaluate the justness and reasonableness of changes to long term service contracts. We found that our statutory responsibilities required us to balance the customers' legitimate expectations of stability against the carrier's business needs and objectives.[1005] We concluded that, if the carrier could show substantial cause for changing the tariff terms, the change would be found reasonable.

471. We then applied the substantial cause standard to the tariff restructuring proposed by RCA American Communications. We found that the new terms of service were not in and of themselves unreasonable. We rejected the tariff, however, because the carrier had not been able to give any good reason why it needed to make the changes it proposed.[1006] We noted that the problems which the carrier sought to address could be solved in ways that did not disturb the legitimate expectations of customers.

472. Our Order rejecting the tariff structure changes was remanded, without opinion, by the D.C Circuit with the request that we provide an "unambiguous statement" of our rationale in order to assist it in evaluating RCA American Communication's claim, on appeal, that we had devised a separate hurdle for the carrier to overcome in addition to proving reasonableness.[1007] In response, we stated[1008]

> It is well established that we have broad authority to interpret the Communications Act and determine when a tariff is just and reasonable. We used that authority in this instance by employing the substantial cause for change test as a tool for defining the appropriate zone of reasonableness applicable to the Americom tariffs. The circumstances that surrounded the Americom filing clearly indicated that customer fairness was an appropriate factor to be considered under the Section 201 reasonableness test.

The court subsequently affirmed our Order.[1009]

1005 RCA American Communications, 86 FCC 2d at 1201.

1006 Id. at 1203.

1007 RCA American Communications, Inc., v. FCC, 684 F.2d 1033 (1982).

1008 RCA American Communications, Inc., 94 FCC 2d 1338, 1340 (1983).

1009 RCA American Communications, Inc., v. F.C.C., Case Nos. 81-1558 and 81-1597 (D.C. Cir., March 8, 1984.). It is thus incorrect to imply, as United does, that the D.C. Circuit's actions in the RCA American Communications cases cast doubt on the lawfulness of the substantial cause test.

473. RCA American then filed a new tariff proposing rate increases for the same fixed term offerings. We again determined that the substantial cause test balances the legitimate expectations of customers against the needs of the carrier.[1010] In applying the test, we found that unforeseeable cost increases, particularly the unexpectedly high inflation that occurred between 1978 and 1981, provided the carrier with substantial cause for a rate increase.[1011]

474. This history demonstrates that we developed the substantial cause test as a tool for evaluating tariff changes in a circumstance in which customers had a legitimate expectation that the change would not occur. In RCA American Communications, the carrier created such an expectation in a few identifiable customers when it offered service for a fixed term. The contract-like offering of a long term tariff is not, however, the only way in which legitimate expectations of rate stability can be created. In our price caps plan, it is this Commission that creates for ratepayers the legitimate expectation that, in general, rates will decrease in real terms from the levels they could expect under rate of return. While carriers may, in their discretion, file above-band rates, we think it appropriate, as part of our carefully-calibrated balance of ratepayer and shareholder interests, to impose the higher burden of the substantial cause test when carriers choose to exceed our price bands.

475. In RCA American Communications, there were only a few customers, most or all of whom were parties to the investigation, so we naturally discussed the extent and manner in which that particular small group of entities had relied on the long term availability of transponder service. Contrary to the assertions of some parties herein, however, there is nothing inherent in a substantial cause requirement that demands that we be able to individually analyze the reliance interests of identifiable customers or discrete groups of customers. Indeed, since we are intentionally creating, for ratepayers as a general class, the general expectation of rates that do not exceed the upper bands, we may presume that they rely on that general expectation. We do not expect the nature and extent of customer reliance typically to be at issue in investigations of above-band rates.

1010 In making this determination we considered and rejected arguments from the carrier that the substantial cause test was created for use in cases of tariff restructuring and could not properly be used to address a proposed rate increase. 2 FCC Rcd 2363 at 2367.

1011 Id. at 2367-68.

476. It should also be clear that "unforeseeability" is not a fixed element of the substantial cause test. Under a rate of return regime in which carriers file rates based on projected costs and demand levels, the question whether cost increases were foreseeable inevitably arises when a carrier proposes, as RCA American did, to change ostensibly long term rates. Under the price cap system we are adopting herein, however, the foreseeability of cost increases is less relevant because prices are not based on projected costs, but on the application of a formula to historical costs. We will not, therefore, adopt the suggestion of TCA that only increases based on "truly unforeseeable" costs be permitted.[1012]

477. What is highly relevant is the carrier's explanation of why it is raising particular rates above the band. We will generally expect to see some causal relationship between the service bearing the increase and the costs which made the increase necessary, and an explanation of why the needed revenues are not being raised through smaller, within-band increases to a wider range of services. On the one extreme, we do not expect to approve an above-band rate which seeks to recover increases in unattributable overheads from one service only. On the other end of the range of possibilities, there may be instances in which a cost increase is so clearly attributable to a service that sharing that increase with other services would constitute a cross-subsidy and an increase above the band would be appropriate.

478. We do not expect to entertain many cases which are as clear-cut as the examples in the previous paragraph. We disagree with the parties who argue that we must provide at this time a detailed specification of what will or will not constitute substantial cause for an above-band rate increase. Since we cannot anticipate now all of the circumstances in which an above-band increase would be just and reasonable, nor all of the possible unjust and unreasonable ways in which rates could be raised, we find it best to refrain from promulgating specific criteria for a successful substantial cause showing. We are introducing a new approach to regulating AT&T, and it is entirely fitting to develop some aspects of this new regime on a case-by-case basis. This is not, as MCI charges, a decision to "wing it." Quite to the contrary, it is a recognition that we must exercise our responsibility to assure just and reasonable rates in a considered and deliberate fashion, and

---

1012 We are also not prepared to state, as TCA would have us do, that increases not based on cost could never satisfy the substantial cause test. On the other hand, we wish to caution AT&T that we do not endorse the position taken by Ameritech that above-band filings may be justified by the need to maintain rate relationships. We do not intend to allow AT&T, having cost-justified an above-band increase for one service, to maintain prior rate relationships by making above-band increases in the rates for other services for which that cost justification does not apply.

that, in some instances, this necessarily involves case-by-case adjudication to flesh out a general standard.

d. Above-Cap Rates

i. Summary of Further Notice

479. In the Further Notice we tentatively found that tariffs proposing above-cap rates would be filed on 90 days' notice, would generally be suspended, and would be required to be accompanied by cost support demonstrating that the rates were just and reasonable. We stated that the cost showing would include cost data for each element in the relevant basket for the most recent four years under price cap regulation, as well as a detailed explanation of the carriers' method of allocating costs among the rate elements. We deemed this extensive showing necessary to allow a determination that the costs driving the increase had been prudently incurred and that the increase was just and reasonable.[1013] We considered using the substantial cause standard, but tentatively determined that that standard would not allow us to scrutinize above-cap filings sufficiently to insure maximim protection of consumer interests within the price cap system.

ii. Pleadings

480. AT&T objects strenuously to our proposal regarding above-cap filings on the grounds that it allows less flexibility and causes more cost and delay than current regulation. AT&T argues that it is not only difficult and expensive, but in some cases impossible, to defend "the necessarily arbitrary allocation of costs on such a minutely disaggregated basis."[1014] AT&T notes that price and cost may not be related at the rate element level, citing as an example PRO America, in which, AT&T claims, there is no way to identify separately the costs of the fixed monthly charge and the usage-based charges.[1015] AT&T also asserts that cost data may have little to do with the reason for an above-cap filing if, for example, an "across-the-basket" increase were proposed.[1016]

481. As an alternative, AT&T advocates a case-by-case approach, much as under the substantial cause standard for above-band filings. According to

---

1013 E.g., that the increase is necessary to avoid confiscation or to ensure acceptable service quality. Further Notice, 3 FCC Rcd at 3375 (para. 319).

1014 AT&T Comments at 30-31.

1015 Id. at 31.

1016 Id. at 31 n.**.

AT&T, this Commission should assess the justification for a rate change in light of the particular circumstances, giving due consideration to carriers' costs, customers' expectations, and other relevant factors. Under AT&T's approach, the data needed to assess an above-cap filing would be determined on a case-by-case basis, depending on the type of change and the reason for it. AT&T also believes that 45 days' notice would be sufficient for an above-cap filing.[1017]

482. Ameritech concurs with AT&T, arguing that the specified cost showing is irrelevant and unreasonable when a rate package is filed in which total revenues for a basket exceed the cap. Ameritech proposes that the showing in such a case be based on total interstate cost and revenue data and that the rates be allowed if justified by extraordinary circumstances.[1018]

483. By contrast, Ad Hoc views our proposed showing as so similar to what the carriers file today that it invites them to make above-cap filings whenever they do not like the rates that they would need to charge to conform to the cap. Ad Hoc sees the above-cap filing as somehow less demanding than the substantial cause showing we proposed for above-band rates.[1019] According to Ad Hoc, the "substantive bottom line" is unacceptable: carriers would be subject only to the traditional standard for carrier-initiated rates, that is, rates would be permitted as long as they were just and reasonable.[1020] Ad Hoc argues that, as a proper balance to the freedom carriers will be gaining to price below the caps, carriers seeking above-cap rates should have to show that such rates are, not merely just and reasonable, but actually necessary to avoid confiscation.[1021]

484. Colorado OCC believes that our proposal merely allows carriers to switch at will from price caps to cost-based regulation and back again.[1022] Colorado OCC also interprets our discussion in the Further Notice as establishing three distinct standards for allowing above-cap rates: 1) the rates are necessary to avoid unlawful confiscation; 2) the rates are necessary to assure acceptable service quality; 3) the rates are necessary to cover costs prudently incurred. Colorado OCC asks whether we will ascertain a

---

1017 Id. at 31-32.

1018 Ameritech Comments at 39-40.

1019 Ad Hoc Comments at 15-16.

1020 Id. at 16.

1021 Id. at 20.

1022 Colorado OCC Comments at 21.

linkage between the service bearing a rate increase and the standard for justification which the carrier invokes. Finally, Colorado OCC asserts that the protection offered against confiscation is more exteme than under rate of return regulation, since rate of return gives investors the opportunity, not the right, to earn a fair return.[1023]

485. Michigan PSC contends that 90 days is too short a time to review the thousands of pieces of paper that would be needed to make an above-cap filing, and suggests that a notice period of a year might be needed.[1024] Ohio proposes that above-cap rates be automatically suspended or even forbidden to take effect without regulatory approval.[1025]

iii. Discussion

486. With minor modifications, we adopt our proposal to require a full cost-based showing for filings proposing above-cap rates.

487. We agree with AT&T that the showing we are adopting is less flexible and more difficult than the showings currently required of AT&T under rate of return. We fully intend it to be. Our price caps scheme grants AT&T significant new flexibility below the cap. Our determination that below-cap rates are presumptively just and reasonable requires us to look closely at all above-cap filings. Furthermore, because the purpose of price caps is to create incentives to reduce costs, consistent with rates falling within the zone of reasonableness, we must choose a method of handling tariffs proposing above-cap rates that preserves those incentives. If we did not examine the cost/price relationships for all services in the basket for which the carrier proposes to exceed the cap, and if we did not inquire into the investment and marketing decisions that led to the above-cap filing, then we would indeed be vulnerable to the criticisms put forth by Ad Hoc and others.

488. We disagree with the parties who contend that the required showing for above-cap rates is insufficiently stringent to restrain AT&T from exceeding the cap at will. While AT&T will be permitted to file above-cap tariffs when it sees fit to do so, and to have such tariffs reviewed on their merits, the showing we are requiring will be extensive and complex. It would take AT&T some time to develop such a showing.[1026] Once filed, it would be

---

1023 Id. at 22.

1024 Michigan PSC Comments at 21-22.

1025 Ohio PUC Comments at 13.

1026 Michigan PSC probably underestimates the scope of this showing at several thousand pages. We note, as we did earlier, that we cannot adopt the suggestion of Michigan PSC that we require longer notice periods for these

virtually certain to be suspended for five months, the maximum time allowed by the Act. Such a filing would be evaluated extremely carefully, in the light of a strong presumption that within-cap rates would be just and reasonable.[1027] We would not anticipate that above-cap rates would be routinely filed or granted, as the burden on AT&T would be greater than under existing procedures or under the substantial cause test. In any event, under our procedures, considerable time would elapse between the time AT&T decided it wanted an above-cap rate and the time such a rate went into effect, if at all. AT&T would not be able simply to switch from price caps back to rate of return regulation. A rational assessment of the possibilities should lead AT&T to the conclusion that an above-cap filing, while permissible, will only be permitted to take effect after suspension, where the justification is compelling, and that the best way to assure continuous profitability is to whole-heartedly pursue the efficiency incentives held out by the price caps program.

489. While AT&T will be given a fair opportunity to justify any above-cap rates, the difficult showing that AT&T must make is reasonable in light of the flexibility given to AT&T with respect to below-cap rates. Moreover, it is quite unikely that, within the next four years, our formula will stray so far from actual costs that the cap will produce unreasonably low rates. We are beginning with existing, carrier-initiated rates; if those rates were not currently high enough, AT&T has had an opportunity to propose rate increases. We are allowing those rates to move with inflation and with changes in access charges and other exogenous costs. The flow-through of

---

filings. The Communications Act does not allow notice periods greater than 90 days. Likewise, we must reject Ohio PUC's suggestion that an above-cap rate be forbidden to take effect until approved; the Act does not allow suspensions longer than five months.

1027 Colorado OCC is incorrect in distilling from the Further Notice three distinct standards for approving an above-cap rate. Its first perceived standard, that the rate is necessary to avoid confiscation, was not a new or extended guarantee against confiscatory rates. The constitutional protection against confiscation is neither limited nor expanded by price caps regulation. Likewise, we mentioned the possibility that a rate increase might be justified on service quality grounds only to make clear that we will not force a carrier to degrade service quality to meet price cap constraints. We did not intend to hold out the promise that rates could routinely go above the cap as long as the carrier claimed the added revenues were needed to maintain service quality. The third standard mentioned by Colorado OCC, prudence of costs, was not mentioned as a reason for allowing above-cap rates but as a limitation upon purported justifications of such rates. In other words, AT&T will not be permitted to raise rates above the cap based on a cost showing unless the costs it shows were prudently incurred.

access charges alone means that AT&T is guaranteed rates reflecting all increases in its single largest expense. The productivity adjustment is well within the various estimates of the long term productivity of the industry; with the addition of the CPD, it represents a productivity goal we believe AT&T can and will exceed, given improved incentives.

490. We do recognize that not every rate element can be assigned a cost. As AT&T notes, one cannot assign costs as between the fixed and usage-based elements of the charges for a service like PRO America. On the other hand, when AT&T originally filed the tariffs for its services it had to demonstrate that the rate structures it proposed would recover the costs of the service. It may not be possible to assign discrete costs to each rate element of each service, but it should be possible to demonstrate how the pricing of each rate element is related to the cost of the service. In making a showing for an above-cap tariff, therefore, we will require AT&T to assign costs down to the lowest possible level, and to make a detailed explanation of the reasons for the prices of all rate elements to which it does not assign costs.

491. One further modification to our proposal is needed. We said in the Further Notice that the allocation of costs within the basket would have to be explained. Upon further consideration, however, it is apparent that we will also need an explanation of the manner in which AT&T has allocated all costs, not just exogenous costs, among baskets if we are to properly evaluate an above-cap filing. Otherwise, if we consider an above-cap filing for one basket without looking at the other baskets, the baskets will not perform their intended function of reducing the likelihood of cross-subsidy between less- and more-competitive services.

e. Below-Band Rates

i. Summary of Further Notice

492. In the Further Notice we proposed that tariffs which would decrease rates by more than 5 percent be filed on 45 days' notice and be accompanied by a showing that the rates cover the costs of providing service and are otherwise just, reasonable, and nondiscriminatory. We did not propose a particular economic standard by which to evaluate cost showings for below-band rates, but we solicited comment on the advantages of adopting a standard, such as average variable cost, for determining whether below-band prices are predatory for tariff review purposes.

ii. Pleadings

493. Parties' positions regarding procedures for reviewing tariff filings proposing below-band rates tend to mirror their positions on the likelihood of predatory pricing under the scheme set forth in the Further Notice and on the necessity of lower price bands. AT&T argues that all price decreases should be presumed lawful, that competitors should bear the burden

of showing that a proposed price decrease is anticompetitive, and that average variable or incremental cost is the appropriate objective test for predation.[1028] LECs, who also generally oppose lower bands, grudgingly support the proposal to allow below-band rates if those rates cover the costs of providing a service. NYNEX, for example, asserts that the proposal to require cost support is more than adequate.[1029] GTOC states that, if some controls are needed, "the least damage might be done by requiring carriers to demonstrate that rate elements decreased by [no] more than a threshold percentage over their marginal cost."[1030]

494. Pactel[1031] and US West[1032] advocate the average variable cost standard, while CBT recommends an incremental cost standard.[1033] SWB, after observing that there is no universal consensus among courts or scholars about cost standards for assessing claims of predation, proposes an "incremental unit cost" standard in lieu of average variable cost.[1034] Ohio PUC and Michigan PSC favor use of a fully distributed cost standard to detect predation.[1035]

495. AT&T's competitors, who see predation as a serious threat under price caps, are critical of the average variable cost standard. Comptel argues that average variable cost has never been employed by this Commission

---

1028 AT&T Comments at 26, 28.

1029 NYNEX Comments at 21; accord Rochester Comments at 16.

1030 GTOC Comments at 42.

1031 Pactel Comments at 49-50.

1032 US West Reply at 52.

1033 CBT Reply at 23. According to CBT, incremental cost differs from marginal cost in that it represents costs incurred in a specific period of time that would not have been incurred if the service were not offered.

1034 SWB Comments at 25-26. SWB states that average variable cost and incremental unit cost are, in theory, closely related. According to SWB, incremental unit costs are the additional costs to a firm of providing a discrete incremental level of output. Average variable costs, SWB states, are the total variable costs divided by output level. SWB notes that the Areeda-Turner test for predation states that prices below short run marginal costs are predatory. SWB then argues that incremental unit costs are a better approximation of short run marginal costs than are average variable costs.

1035 Ohio PUC Comments at 20; Michigan PSC Comments at 14.

and may prove infeasible in the context of the telecommunications industry. Comptel also believes that adoption of any cost standard may be beyond the scope of the instant proceeding, because development of a cost standard is an immensely complex undertaking requiring, among other things, the specification of cost allocation methodologies.[1036] US Sprint states that an average variable cost standard is unworkable and subject to manipulation by AT&T, since it is AT&T that controls the cost information. According to US Sprint, carrier-submitted data purporting to justify average variable cost pricing are extremely difficult, if not impossible, to evaluate.[1037]

496. NTN attacks average variable cost as a weak standard which would permit AT&T to pierce the lower bands at any time.[1038] NTN quotes academic authority for the propositions that a monopolist with economies of scale may be able to discourage competition without pricing below average variable cost, and that a monopolist with excess capacity may be able to implement such a strategy without pricing below average total cost.[1039] NTN then argues that, since AT&T enjoys both economies of scale and excess capacity, use of the average variable cost standard will not only not prevent AT&T from predating, but will amount to practical deregulation of AT&T's prices.[1040] NTN also contends that average variable cost, to the extent it has been adopted by courts, has been used only as a threshold below which prices could be presumed predatory, and that this is not the same as adopting average variable cost as a criterion for deciding whether a firm has engaged in predation.[1041]

497. In reply, AT&T asserts that the analysis upon which NTN relies was intended to address a situation in which a monopolist could acquire excess capacity for the sole purpose of discouraging competitive entry. AT&T states that this analysis is irrelevant to the interexchange industry, because numerous competitors already have sunk excess capacity that cannot be driven

---

1036 Comptel Comments at 24-25; Comptel Reply at 13.

1037 US Sprint Reply at 15.

1038 NTN Comments at 16-20.

1039 NTN Comments at 16-17, quoting Scherer, Predatory Pricing and the Sherman Act: A Comment, 89 Harv. L. Rev. 869, 871 (1976).

1040 NTN Comments at 17, 19; accord Cable & Wireless Comments at 31.

1041 NTN Comments at 18. NTN also cites a string of cases which, it claims, demonstrates that courts do not fully accept average variable cost as a test for predation. Id. at n.27.

out of the market by AT&T's lowering its prices.[1042] AT&T cites its own academic authority to the effect that, in order to avoid chilling competitive price reductions, this Commission should require a strong showing to rebut that presumption, and should entertain such challenges only after the price increase has taken effect and actual market evidence is available.[1043]

iii. Discussion

498. We affirm our tentative conclusion that a tariff proposing below-band rates should be filed on 45 days' notice and accompanied by a showing that the rates cover the cost of service and are otherwise just, reasonable, and nondiscriminatory. For the purpose of initial review of such tariffs, we adopt the average variable cost standard as the standard for determining whether a proposed rate decrease must be suspended pending investigation.

499. Price reductions are ordinarily good for consumers, though not pleasing to competitors. Predatory pricing, though often alleged, is generally uncommon, and proven cases are rare.[1044] We have, through the structure of AT&T's service baskets[1045], created conditions under which predation should be as unlikely in the interexchange telecommunications market as it is in the economy generally. Although an abundance of caution has led us to deny streamlined treatment to below-band rate decreases, we are convinced that such below-band reductions as are possible within the limits of our price cap scheme are more likely to be competitive than predatory. Such reductions should, therefore, be reviewed against a standard which requires suspension only of those rates which are so low that they can be presumed to be anticompetitive. As AT&T's competitors point out, average variable cost is just such a standard.

1042 AT&T Reply at 44-45.

1043 AT&T Reply at 45-46, citing statement of P. Areeda, AT&T Comments, Appendix A at 12-13, and P. Areeda & D.F. Turner, Scherer on Predatory Pricing: A Reply, 89 Harv. L. Rev. 891, 897 (1976). AT&T also cites numerous court cases in support of the position that average variable cost is a rational test that permits genuine price competition while protecting against predation. AT&T Reply at 47 n.*.

1044 See P. Areeda & D. Turner, Antitrust Law (1978) ¶711; R. Koller, The Myth of Predatory Pricing: An Empirical Study, 4 Antitrust L. & Econ. Rev. 105 (1971); see generally J. Kwoka & L. White, The Antitrust Revolution (1989).

1045 See Section III.C.2., supra.

500. While there is not unanimity on the proper definition of predatory pricing[1046] an examination of the opinions of academic commentators, the Supreme Court of the United States, parties to this proceeding, and others cited by the parties in the record of this proceeding, demonstrates that the question whether prices are below marginal cost, or its surrogate, average variable cost, is central to the determination of whether they are predatory. Disagreement exists on the point at which prices can be presumed legal, and on the role of intent in finding antitrust violations.[1047] In adopting average variable cost as a tariff review standard, we do not find that all rates which cover average variable costs are necessarily just and reasonable. Petitioners may be able to show that there is reason to investigate a rate decrease which we permit to go into effect after 45 days. Competitors can also file complaints alleging predatory pricing. In either case, it might be possible to show that the resulting rate is above average variable cost but nonetheless predatory using relevant antitrust analysis and precedent.[1048]

501. The record in the instant proceeding does not provide us with a firm basis for specifying precisely what are the average variable costs of various telecommunications services. We do observe, however, that the average variable cost of any service must include all access charges and billing and collection costs attributable to that service, as well as other non-fixed costs which would not be incurred if the service were not offered.

f. New and Restructured Services

i. Summary of Further Notice

502. In the Further Notice, we stated that new and restructured services present special considerations because of the opportunity they present to carriers to charge rates that otherwise would not be permitted under our price

---

1046 See, e.g., Further Notice, 3 FCC Rcd at 3372, n.709, and cases cited therein; Areeda & Turner, Predatory Pricing and Related Practices under Section 2 of the Sherman Act, 88 Harv. L. Rev. 697 (1975); McGee, Predatory Pricing Revisited, 23 J. Law & Econ. 289 (1980); Cargill Inc. v. Monfort of Colorado, 479 U.S. 104, 117 n.12 (1986).

1047 See Cargill, 479 U.S. at 117, n.12, comparing Arthur S. Langenderfer, Inc. v. S.E. Johnson Co., 728 F.2d 1050, 1056-1057 (6th Cir.) cert. denied, 469 U.S. 1036 (1984), with Transamerica Computer Co. v. International Business Machines Corp., 698 F.2d 1377 (9th Cir.), cert. denied, 464 U.S. 955 (1983).

1048 Parties aggrieved by allegedly predatory pricing may also press their allegations in court under the antitrust laws.

cap rules.[1049] We found that while the offering of a new or restructured service potentially furthers our goal of increasing carrier innovation and cost-effectiveness, such an offering raises issues of rate discrimination as well as anticompetitive concerns.[1050] We tentatively concluded that it would be necessary to treat tariffs involving new and restructured services differently from tariffs that only specify rate level changes in order to discourage carriers from manipulating price cap regulation.[1051]

503. We tentatively concluded that an offering increasing customer options should be classified as new, while an offering that represents a change in an existing method of charging or provisioning, without increasing the range of alternatives, should be classified as restructured.[1052] We further concluded that new and restructured services presented different problems which required different treatment.

504. We proposed that new services should initially be offered outside of price cap regulation, and incorporated into price caps in the first annual filing after the completion of the base year in which the service becomes effective. We tentatively concluded that carriers seeking to introduce a new service would be required to demonstrate that the service met a modified version of the "net revenue test" established in the Optional Calling Plan Order.[1053] We proposed that a new service must generate a net revenue increase within the lesser of the following time periods: 24 months after the effective date of the annual price cap tariff incorporating the new service, or 36 months from the date that the new tariff becomes effective.[1054] We tentatively concluded that the net revenue increase should be measured against revenues generated from services in the same price cap basket.[1055] In order

---

1049 3 FCC Rcd at 3320 (para. 232).

1050 Id. at 3320-21 (para. 233).

1051 Id. at 3321 (para. 234).

1052 Id. at 3377 n.720 (para. 325).

1053 Id. at 3376 (para. 322)(citing Guidelines for Dominant Carriers' MTS Rates and Rate Structure Plans, CC Docket No. 84-1235, Memorandum Opinion and Order, 50 Fed. Reg. 42,945 (Oct. 23, 1985), 59 R.R.2d 70 (1985) (Optional Calling Plan Order)).

1054 Id. at 3376-77 (para. 323).

1055 Id. at 3377 (para. 324).

to afford adequate opportunity for review, we tentatively concluded that tariffs proposing new services should be filed on 45 days' notice.[1056]

505. For restructured services, we proposed that carriers file tariffs on 45 days' notice, and that carriers demonstrate that restructuring will not result in actual prices that fall outside price cap requirements.[1057] We tentatively concluded that tariffs proposing both below-cap, within-band rate level changes and restructuring should be filed on 45 days' notice, and that we should retain our existing notice periods for filings that correct tariffs or represent one of the tariff changes contemplated in Section 61.58(c)(1)(ii) and (iii).[1058]

ii. Pleadings

506. New Services. In general, AT&T and the LECs argue for a more relaxed approach to new services, while AT&T's competitors contend that review should be strict. The dominant carriers focus on three areas: streamlining, a longer "payback" period under the net revenue test, and a lengthy, or even permanent exclusion from caps. Competitor's concerns center on predatory pricing of new services and on use of new services to evade price bands on existing services.

507. AT&T contends that streamlined review will encourage new services and prevent delays in their introduction.[1059] AT&T states that this Commission's authority to suspend and investigate is sufficient to prevent undesirable results.[1060] CCIA also argues that if there is no effect on MTS, there should be no constraints on the new service.[1061] Comptel, however, opposes streamlining as an invitation to anticompetitive conduct on the part of AT&T.[1062]

1056 Id. at 3376 (para. 322).

1057 Id. at 3377-78 (para. 325).

1058 Id. at 3378-79 (para. 327). The references in the text, above, are to provisions of Section 61.58 before amendment of the rules by this Order. Section 61.58(c) has been redesignated Section 61.58(d). See Appendix B.

1059 AT&T Comments at 33-34; AT&T Reply at 55.

1060 AT&T Reply at 55.

1061 CCIA Comments at 13.

1062 Comptel Reply at 15.

508. Several dominant carriers contend that new services should remain uncapped for a longer period than that proposed in the Further Notice. AT&T argues that services should be uncapped for three to five years in order to provide the necessary experience with cost and demand to set the price, and to ensure that AT&T will recoup its investment. AT&T suggests that an ideal solution would be to continue the uncapped state permanently.[1063] CBT proposes that the time out of cap be extended beyond the initial four years of price cap regulation because many services take years to develop and a history of demand is necessary.[1064] US West proposes capping new services after five years, but agrees with AT&T's experts that it may not be necessary to cap new services at all. US West contends that it is important to cap stable prices.[1065]

509. Bell Atlantic and BellSouth seek an extension of the time provided for the service to increase net revenue. Bell Atlantic proposes 48 months, arguing that the shorter payback period was designed for new pricing plans for MTS, and that new services often entail significant capital investment.[1066] BellSouth also advocates a longer period, arguing that new technologies may take longer to win marketplace acceptance.[1067]

510. AT&T and exchange carriers favor use of the net revenue test, subject to certain modifications and clarifications. AT&T, GTOC, and CBT seek clarification that the net revenue test excludes does not require allocation to new services of joint costs.[1068] In this regard, AT&T contends that prices based on a fully distributed cost (FDC) standard would chill innovation and discourage new services.[1069] Bell Atlantic, GTOC, and CBT request that the net revenue test apply to services, and not rate elements.[1070] CBT argues for

---

1063 AT&T Comments at 35 (citing AT&T Comments to Notice, App. C, statement of W. Baumol and R. Willig, at 34); AT&T Reply at 54 n.**.

1064 CBT Comments at 10; CBT Reply at 12-13.

1065 US West Reply at 47-48.

1066 Bell Atlantic Comments at 6 n.12.

1067 BellSouth Comments at 59.

1068 AT&T Reply at 56 n.*; GTOC Comments at 47; CBT Reply at 27.

1069 AT&T Reply at 56 n.*.

1070 Bell Atlantic Comments at 6 n.12; GTOC Comments at 47-48; CBT Reply at 27.

annual, rather than quarterly reports, contending that reports before the service is capped are not useful and could discourage new services.[1071] NYNEX contends that while the net revenue standard is appropriate to determine the demand revenue effect of new services, it is unduly cumbersome to use the net revenue test to track expenses associated with new services on a service-by-service basis.[1072]

511. AT&T's competitors state concerns about predatory pricing of new services. US Sprint argues that there are really two kinds of new services: "repriced" offerings that represent discounts from existing services; and "genuinely new" offerings that involve new technologies or new capabilities. US Sprint states that almost all of AT&T's new offerings fall into the "reprice" category, and that almost all are subject to competition. Therefore, US Sprint argues, the danger is that they will be priced too low, not too high.[1073] US Sprint believes that the net revenue test would not address effectively the problem of predation, and that the incentive to predatorily price or cross-subsidize new services can best be minimized by capping competitive services separately from less competitive services, and by enforcing market rules. These market rules would include the prohibition on resale restrictions, and a requirement that services must be generally available.[1074] Cable & Wireless, however, argues that this Commission's market rule on resale restrictions can be avoided.[1075]

512. Competitors of AT&T and others criticize the net revenue test as inaccurate,[1076] insufficiently developed,[1077] and subject to

---

1071 CBT Comments at 10-11.

1072 NYNEX Comments at 48.

1073 US Sprint Comments at 30. US Sprint states that if the new service is not competitive, it is unlikely to be priced too low, but that it cannot be priced too high, or customers will stay with the existing substitute service. Id. at 30-31. Accord ACTA Comments at 6; ALC Comments at 18; Comptel Comments at 32; Illinois Comments at 27-28; NTN Comments at 12; PRTC Comments at 28.

1074 US Sprint Comments at 31; US Sprint Reply at 14.

1075 Cable & Wireless Comments at 35 n.39.

1076 US Sprint Comments at 40.

1077 Cable & Wireless Comments at 36; US Sprint Comments at 35. US Sprint also argues that if, as AT&T contends, the data required for the proper application of price caps to new services will be unavailable for 3-5 years,

manipulation[1078] and past abuse.[1079] US Sprint contends that quarterly reports would be valueless because it would be impossible to evaluate the costs assigned to the plan.[1080] Comptel argues that this Commission has no remedy if the new service does not achieve its demand and revenue projections.[1081]

513. Several parties seek clarification of the net revenue test. MCI asks why it is necessary to modify the net revenue test, and NARUC requests an explanation of the application of the net revenue test.[1082] US Sprint asks this Commission to specify the data and supporting information that must be filed to satisfy the net revenue test.[1083] Michigan PSC and NARUC request clarification of how much time will elapse before the new service is capped.[1084]

514. ALC and Cable & Wireless argue that AT&T will use the new service classification to escape rate bands.[1085] In addition, Cable & Wireless argues that the treatment of new services will permit price discrimination.[1086] MCI contends that AT&T could strategically engineer its prices for new services in and out of the cap to maximize profits. MCI argues that if AT&T raises the price of the new service before it is capped, AT&T could then lower the price of the new service and raise the price of another service. In addition, MCI contends that the treatment of new services will

---

the net revenue test will not be probative. US Sprint Reply at 14.

1078 ALC Comments at 18; Comptel Comments at 31-32; Michigan PSC Comments at 20.

1079 PRTC Comments at 26-27.

1080 US Sprint Comments at 36.

1081 Comptel Comments at 32.

1082 MCI Comments at 73 n.14; NARUC Reply at App. C.

1083 US Sprint Comments at 43.

1084 Michigan PSC Comments at 20; NARUC Reply at App. C.

1085 ALC Comments at 19; Cable & Wireless Comments at 35; Cable & Wireless Reply at 14.

1086 Cable & Wireless Comments at 35.

give AT&T incentives to introduce new services earlier.[1087] NTN contends that new services could be limited to a few customers, and US Sprint argues that a new service designed for a single customer would present difficulties because it would require detailed information on that customer's decision-making.[1088]

515. Based on their criticisms of this Commission's proposed treatment of new services, AT&T's competitors recommend certain changes in our approach. ACTA and PRTC propose a duration requirement for new prices. ACTA argues that AT&T should be required to demonstrate that the net revenue test is satisfied at the initial price of the new service and at some lower price.[1089] PRTC, ACTA, and US Sprint also argue that AT&T should be required to specify the basket in which the new service will be placed, and that this Commission should review the choice of baskets.[1090] US Sprint and Cable & Wireless argue that new services should be reviewed under standard tariff cost support rules, not the net revenue test.[1091] Michigan PSC proposes that when the new service is capped, AT&T should be required to base its price on fully distributed costs.[1092] Finally, US Sprint suggests that "genuinely new" services be permitted supranormal profits as a reward for entrepreneurship, and that they be kept out of the cap until it is clear whether they are competitive.[1093]

516. Restructured Services. AT&T proposes that streamlined treatment be afforded restructured services. AT&T contends that denying streamlined treatment to restructured services would unduly limit AT&T's flexibility without benefiting ratepayers.[1094] AT&T argues that the underlying service will have been subject either to conventional tariff review, or to the net revenue test, and that competition assures restructuring will be reasonable. In the event that it is unreasonable, AT&T contends, this Commission can use our Section 204 investigatory powers, or the complaint

---

1087 MCI Comments at 74-76.

1088 NTN Comments at 12; US Sprint Comments at 42.

1089 ACTA Comments at 17; PRTC Comments at 29.

1090 PRTC Comments at 31; ACTA Comments at 18-19; US Sprint Comments at 44.

1091 US Sprint Comments at 36; Cable & Wireless Comments at 36; Cable & Wireless Reply at 14.

1092 Michigan PSC Comments at 20.

1093 US Sprint Comments at 32-33.

1094 AT&T Comments at 32-33.

process.[1095] AT&T states that it has filed 550 tariffs for new and restructured services since divestiture, of which only 80 were challenged, and of these, only 20 were modified or withdrawn.[1096]

517. Competitors and customers oppose AT&T on this issue. TCA argues against streamlined treatment for restructured services on the grounds that restructuring can be an instrument of discrimination.[1097] ICA also supports 45-day review, and Comptel argues that streamlining will enable AT&T to avoid cost justification altogether.[1098] US Sprint supports our proposed treatment of restructured services, and states that AT&T should be required to calculate the API.[1099] In addition, Comptel and Cable & Wireless express the concern that restructuring will permit AT&T to evade the bands and pursue anticompetitive pricing and uncompensatory rates.[1100] Cable & Wireless contends that this Commission should reject any tariff proposing restructured rates that exceed the bands.[1101]

iii. Discussion

518. We conclude that new and restructured services must receive special treatment because they present a possible means of avoiding the price cap pricing restrictions. New and restructured services, if they are innovative, or more efficient, foster our goals of encouraging innovation and cost-effectiveness, and this potential militates in favor of flexible treatment of these services. On the other hand, new and restructured services raise complex issues, including discrimination and the possibility of anti-competitive behavior, which require careful review. We therefore adopt the tentative conclusions of the Further Notice with regard to the treatment of new and restructured services. Tariffs for restructured services will be filed on 45 days' notice, and must demonstrate continued compliance with the PCI and the bands. Tariffs for new services will also be filed on 45 days'

1095 Id. at 32 n.**, 33

1096 AT&T Reply at 53.

1097 TCA Reply at 22 n.46.

1098 ICA Comments at 31; Comptel Reply at 14.

1099 US Sprint Comments at 34-35.

1100 Comptel Comments at 33-34; Cable & Wireless Reply at 14.

1101 Cable & Wireless Reply at 14.

notice and must demonstrate compliance with the modified version of the net revenue test set forth below.[1102]

519. New and restructured services present different issues, and must be treated differently. The general principle for distinguishing between new and restructured services was laid out in the Further Notice. New services add to the range of options available to customers, while restructured services simply represent rearrangements of existing services. A service may be restructured by changing an existing method of charging or provisioning, by changing a term or condition, by adding language, by adding, consolidating, or eliminating rate elements. When a service has been restructured, the previous version of that service no longer exists. A new service may, but need not, include a new technology or new functional capability.[1103] It may be a partial substitute for an existing offering, as long as the existing offering remains available, and the range of alternatives available to consumers is increased by the introduction of the new service. The 45-day notice period applicable to both new and restructured services will allow us to detect and require correction of mischaracterized filings.

520. New Services. We conclude that permitting new services a brief period of relative flexibility will stimulate carrier incentives to innovate, and enable AT&T to develop historical demand figures necessary for our price cap formulas. Therefore, although our review of new services will involve an examination of their effect on the revenues of capped services, new services will be outside the cap initially. This temporary treatment constitutes an exception to our general policy that all existing services should be capped. Tariffs proposing new services should be filed on 45 days' notice, with supporting information and data to demonstrate compliance with the net revenue test described below. AT&T must include new services in the

---

1102 As we stated in the section discussing service exclusions, new services offered under the current configurations of Tariffs 12, 15, and 16 shall be given conventional tariff review. Such services shall not be reviewed under the net revenue standard and shall not be eligible for inclusion in price caps after a brief waiting period. Additional contract-type tariffs shall be considered on a case-by-case basis. See Section III.C.2.a., supra.

1103 We reject the suggestion that only services offering new functional capabilities be treated as "new." As the parties have observed, it is rare that a wholly different form of telecommunications service is offered. Many new services are, in essence, repriced versions of already-existing services. As long as the pre-existing service is still offered, the repriced version cannot be considered to be the same service as the pre-existing one. More important, a repriced service, such as a new optional calling plan, presents precisely the issues that our application of the net revenue test to new services is designed to address.

cap in the first annual price cap tariff filing after the completion of the base year in which the new service becomes effective.

521. In the Optional Calling Plan Order, we found that fully distributed costing was not necessary to prevent cross-subsidization of a new, competitive optional calling plan by less competitive switched services. We recognized that a price lower than FDC, but higher than marginal cost, would not only recover the costs caused by a service, but contribute to overhead as well. We further found that, while FDC would definitively rule out predation, it would do so at an unwarranted cost. Depending on the degree and nature of competition, FDC would either preclude offering of the new service altogether, or erect an inefficient price umbrella over less efficient competitors. Based on these conclusions, we decided that an FDC standard should not be used as a means of determining the reasonableness of rates for new optional MTS calling plans. We concluded that we should use a standard that more closely approximates marginal or incremental cost. Because marginal costs are essentially theoretical, however, and cannot be generated through conventional accounting methods, we decided to employ a net revenue test as a proxy for a marginal cost standard.[1104]

522. We now conclude that the same considerations that led us to reject FDC as a standard for optional calling plans apply to all new AT&T services under price caps. Consumer welfare will be increased by the introduction of a new service if that service produces revenues that cover at least the incremental costs of providing the service. If a new service increases AT&T's net revenues for price cap services, we can assume that it is recovering at least its incremental costs. We believe, therefore, that the net revenue test is the best approach to determining whether the introduction of a new service under price cap regulation will increase the options available to consumers without resulting in unreasonable discrimination, unjust or unreasonable rates, cross-subsidization, or an increase in the prices of existing services.[1105]

523. The net revenue test we now establish for new services is identical in most respects to the test set out in the Optional Calling Plan Order.

1104 Optional Calling Plan Order at paras. 19-21.

1105 We thus reject the arguments of parties favoring application of an FDC standard to new services. We also reject the proposal that we require conventional cost support for new services instead of using the net revenue test. Though it might be possible to implement an incremental cost standard through conventional tariff procedures, we believe it is better to use the existing, tested methodology of the net revenue test. See generally AT&T Communications, Revisions to Tariff F.C.C. No. 1 (PRO America), FCC 86-249, released May 14, 1986.

Because of differences between price cap and rate of return regulation, certain technical modifications must be made. In the discussion that follows we describe the guidelines established by the Optional Calling Plan Order, and explain the modifications that are necessary to adapt the test to price cap regulation. We then restate the net revenue test to incorporate these modifications.

524. The Optional Calling Plan Order establishes eight guidelines for compliance with the net revenue test. First, the projected increase in net revenues is to be measured on a present value basis.[1106] This guideline need not be modified for price cap purposes. Second, the new service must increase the carrier's net revenues for switched services, that is, its total switched services revenues less its total cost of providing switched service offerings, including access charges.[1107] We adopt the definition of net revenues, but modify this guideline to require that the new service increase the net revenues of price cap services, as described below in the discussion of the fifth guideline.

525. Third, the proposed new service must increase net revenues within 12 months after the effective date of any access tariff revisions that reflect the proposed stimulation due to the new service, but in any event, within 36 months after the effective date.[1108] We adjust this guideline for price cap regulation by requiring that the new service be projected to increase net revenues within the lesser of the following time periods: 24 months from the incorporation of the new service in an annual price cap tariff, or 36 months from the effective date of the service.[1109]

526. Fourth, if a particular element of a new service is offered separately, and there is a risk of anticompetitive behavior, this Commission will require the carrier to show that the element is priced in a way that is consistent with the net revenue test. As long as the optional calling plan as a whole, and each optional calling plan element that is offered separately to customers, meets the standard, we are not concerned with applying the test to each and every rate element.[1110] We adopt this guideline without

---

1106 Optional Calling Plan Order at para. 49.

1107 Id. at para. 50.

1108 Id. at para. 51.

1109 Bell Atlantic and BellSouth request a longer "payback period" for new services incorporating new technologies. We do not anticipate that such an extension of time will be necessary for the bulk of new service offerings. The waiver process remains available for unusual circumstances.

1110 Id. at para. 52. We explicitly did not require in the Optional Calling

modification. Fifth, AT&T is required to demonstrate a net increase in switched services revenues rather than an increase in revenues for the firm as a whole, or in MTS revenues.[1111] We must modify this guideline. In the Optional Calling Plan Order we required that an MTS optional calling plan increase switched services revenues, rather than just MTS revenues, because we found that application of the net revenue test across the broader group of services was necessary to reflect proper cross-elasticities of demand.[1112] In the Further Notice we proposed to apply the net revenue test with respect to the services within the basket in which a new service would later be placed. Under the two-basket structure proposed in the Further Notice, application of the net revenue test at the basket level was consistent with the approach followed the Optional Calling Plan Order. Under the three-basket structure we adopt in this Order, however, services which may be cross-elastic are contained in different baskets. Therefore, in order to reflect proper cross-elasticities of demand, we must apply the net revenue test to all price cap services.

527. Sixth, the Optional Calling Plan Order guidelines require that the dominant carrier provide and explain the assumptions and estimates filed with a proposed new service, including reliable information on demand, cost, revenue, and elasticity and cross-elasticity of demand. Seventh, the carrier must explain how costs are allocated to the new service.[1113] We retain both of these requirements in full. Eighth, the carrier must file quarterly financial reports comparing actual operating results with projections. Reports are due no later than the end of the next quarter following.[1114] We retain this requirement, and specify that the first quarterly report is due six months after initiation of the service. These reports will help this Commission to monitor whether a new service is increasing or is likely to increase net revenues, and to decide whether action on our part is necessary.

528. Accordingly, we adopt the following requirements for the introduction of new services into our price cap system of regulation:

Net Revenue Standard.

Plan Order, and do not require here, that each rate element satisfy the net revenue standard.

1111 Id. at para. 53.

1112 Id.

1113 Id. at para. 54.

1114 Id. at para. 55.

(a) A new service, and each unbundled element thereof, must be projected to increase AT&T's net revenues for services subject to price cap regulation .

(b) The increase must be projected to occur within the lesser of the following time periods: 24 months from the incorporation of the service into an annual price cap filing, or 36 months from the effective date of the service.

Required Showing.

(a) Revenue effects shall be measured on a present value basis.

(b) AT&T shall support its net revenue projections with detailed information on demand, cost, revenues, elasticity, and cross-elasticity of demand associated with the new service.

(c) All assumptions, estimates, and cost allocation methods employed in developing that information shall be fully explained.

Reporting.

AT&T must file quarterly reports comparing actual operating results with projections, beginning six months after the initiation of the new service.

529. Finally, we reiterate the requirement set forth in the Optional Calling Plan Order that new services may not impose unreasonable restrictions on customers, resale, sharing, or interconnection.[1115]

530. We reject AT&T's proposal that we apply streamlined tariff review to new services. Both we and interested parties will need the time provided by a 45-day notice period to determine whether a new service raises issues of anticompetitive or discriminatory behavior or unjust and unreasonable rates. We also reject proposals to allow new services to remain uncapped for a longer period of time, or permanently. We have concluded that all services should

---

1115 Id. at para. 77.

be capped unless there is a strong reason for exclusion, and new services as a group do not present such a case.[1116] Moreover, if services are not capped in fairly short order, new services could, as some commenters contend, provide AT&T with the opportunity to manipulate prices to avoid the cap and the bands.

531. The possibility that AT&T will predatorily price new services is addressed both by our revised approach to baskets and bands, which should eliminate costless predation,[1117] and by the net revenue test, which ensures that rates will cover incremental costs.[1118] As in the case of services being offered at the outset of price caps, we also rely to some extent on our requirements of resale and general availability, and on the complaint process.[1119] We do not believe that a duration requirement, or the variant proposed by ACTA,[1120] is an appropriate additional requirement because each would restrict carrier flexibility without directly inhibiting anticompetitive pricing.[1121]

532. We share some of the concerns expressed by commenters about the accuracy of the net revenue test and the extent to which the test may be subject to manipulation by carriers. We address these concerns through the quarterly report requirement. By requiring reports comparing actual and projected revenues on a quarterly basis, beginning six months after initiation of service, we will be able to ascertain the accuracy of the forecasts fairly

---

1116 We believe this is true even if the new service is, as US Sprint posits, a "genuinely new" service. See US Sprint Comments at 32-33 (proposing that a service offering new technology remain uncapped until it is clear whether it is competitive). We will review AT&T's choice of basket assignments for the new service, and we do not believe it is necessary, or beneficial, to leave any new service uncapped indefinitely.

1117 See Section III.C.2, supra. See also US Sprint Reply at 14.

1118 MCI argues that AT&T could price a new service high, in order to use the reductions to raise prices for other services once the new service was capped. We conclude that the demand weight for the new service at the time it is capped is likely to be so small that AT&T will have little opportunity for such gamesmanship.

1119 If a new service is structured as a custom tariff, the exclusion rules and tariff review standards set forth in Section III.C.2, supra, will control.

1120 See ACTA Comments at 17.

1121 See Optional Calling Plan Order at para. 86 (rejecting duration requirement).

quickly. To the extent that AT&T consistently underestimates costs, or overestimates demand or revenues, we would expect to take that into consideration in our review of AT&T's new service filings.[1122]

533. Restructured Services. Tariffs proposing restructured services are much more likely to raise issues of discrimination than tariffs proposing only rate level changes. We therefore conclude that the streamlined review afforded below-cap, within-band filings is insufficient for restructured services. Rather, we require that tariffs proposing restructured rates be filed on 45 days' notice. AT&T has claimed that less than 4 percent of its new and restructured tariffs have been modified or withdrawn since divestiture.[1123] Our obligation to prevent discrimination and ensure just and reasonable rates operates regardless of the percentage of unlawful tariffs. The more serious concerns about discrimination and rate levels that may arise with respect to restructured services cannot be addressed adequately in 14 days, and we therefore retain the conventional tariff review period for restructured services.[1124]

534. Some of AT&T's competitors contend that restructured services could constitute an evasion of bands. At least in the case of Comptel, the primary concern appears to be below-band rates, and possible predatory pricing.[1125] We have countered the potential threat of predatory pricing with our approach to baskets and bands.[1126] As restructured services will remain in their baskets, and continue to be subject to banding limitations, we believe the problem of predatory pricing has been adequately addressed.

D. Effect of Incentive Regulation on Existing Commission Policies

1. Geographic Rate Averaging

1122 Cf. Annual 1988 Access Tariff Filings, Memorandum Opinion and Order, 3 FCC Rcd 1281 (1987) at para. 192 (stating that the Common Carrier Bureau will place less confidence in present forecasts made by a carrier when that carrier's forecasts for prior periods have been inaccurate).

1123 AT&T Reply at 53.

1124 As we discuss in Section III.D.1., infra, proposed tariffs that would serve to geographically deaverage rates will be given exhaustive scrutiny by this Commission, and the notice period will be extended to the full 90 days permitted under statute.

1125 See Comptel Comments at 33-34.

1126 See Section III.C.2, supra.

a. Summary of Further Notice

535. In the Further Notice, we underscored our commitment to geographic rate averaging, and stated that price cap regulation would not affect this commitment. We noted that geographic rate averaging has proven effective in protecting rural ratepayers and customers of high cost LECs from unduly large common line cost recovery burdens, and has permitted rural consumers to share the benefits of increased interexchange competition in densely populated areas.[1127] We stated that in the past we have found it unnecessary expressly to prohibit deaveraging because we believe that carriers will continue their current practices regardless of the development of competition, and we tentatively concluded that it is unnecessary for price cap rules to include any specific prohibitions regarding deaveraging.[1128]

b. Pleadings

536. Carriers, state commissions, and users favor geographic rate averaging.[1129] Parties state that geographic rate averaging supports this Commission's policy of universal service.[1130] States and exchange carriers assert that rate averaging protects rural ratepayers from unduly large common line costs, and permits them to share in the benefits of urban competition.[1131] NTCA and Rochester also state that averaging contributes to the simplicity and clarity of the residential customer's choice of long distance carriers.[1132] AT&T and Pactel state that price caps for AT&T will not affect geographic rate averaging.[1133] Indeed, AT&T argues that price caps will support averaging by giving AT&T the flexibility it needs to

---

1127 3 FCC Rcd at 3450-51 (para. 480).

1128 Id. at 3452 (paras. 484-85).

1129 Pactel Comments at 54; Wisconsin PSC Comments at 2; NRTA Comments at 8; NTCA Comments at 17-18; USTA Comments at 18; Alaska Comments at 1, Alascom Reply at 4; Hawaii Reply at 5; Rochester Reply at 24; API Reply at 27; Alabama PSC Comments at 3.

1130 NRTA Comments at 8; NTCA Comments at 17-18; USTA Comments at 18, 23; Alaska Comments at 1, 41; Alascom Reply at 4; Hawaii Reply at 4.

1131 API Comments at 27; NRTA Comments at 2; Hawaii Comments at 17, 19; Alabama PSC Comments at 3; Rochester Reply at 24.

1132 NTCA Comments at 18; Rochester Reply at 24.

1133 AT&T Comments at 7 n.*; AT&T Reply at 24; Pactel Comments at 54.

compete.[1134] Missouri PSC argues, however, that price cap regulation will give AT&T an incentive to deaverage rates in order to raise prices in geographic areas where there is less competition.[1135] AT&T states that it is committed to continuing geographic rate averaging.[1136] Alaska and Alascom contend that this Commission should not rely on AT&T's statement of commitment.[1137] A number of carriers and states argue that this Commission should adopt a rule prohibiting deaveraging.[1138] Virginia asserts that we should base our decision on the necessity of a rule upon data regarding the quality and availability of competitive alternatives, and not on assumptions about carrier motives.[1139] NTCA contends that the price cap proceeding represents another critical point in the effort to maintain uniform rates that justifies adoption of specific rules.[1140] Rochester states that if this Commission decides not to establish a rule, we should monitor rates carefully.[1141]

1134 AT&T Reply at 25.

1135 Missouri PSC Comments at 8-9.

1136 AT&T Comments at 7 n.*; AT&T Reply at 24.

1137 Alaska Comments at 4; Alascom Reply at 5.

1138 NRTA Comments at 2; NTCA Comments at 18-19; TDS Comments at 15; USTA Comments at 23; Hawaii Comments at 17, 19; Missouri PSC Comments at 9; Virginia Comments at 4; Alascom Reply at 6; Independents Reply at 19; NTCA Reply at 11-12; OPASTCO Reply at 9-10; TDS Reply at 10; TUECA Reply at 6; USTA Reply at 48.

1139 Virginia Comments at 4.

1140 NTCA Reply at 11-12.

1141 Rochester Reply at 24.

c. Discussion

537. This Commission has repeatedly voiced our support for rate averaging and we here reaffirm that policy.[1142] Geographic rate averaging redounds to the benefit of rural ratepayers, and customers of high cost local exchange carriers. First, geographic rate averaging ensures that interexchange rates for rural areas, or areas served by high cost companies, will not reflect the disproportionate burdens that may be associated with common line cost recovery in these areas. Thus, geographic rate averaging furthers our goal of providing a universal nationwide telecommunications network.[1143] Second, geographic rate averaging ensures that ratepayers share in the benefits of nationwide interexchange competition. If prices are falling due to competition in the corridors carrying the most traffic, prices will also fall for rural Americans. An additional benefit of rate averaging has been its contribution to the simplicity of MTS rates. Customers seeking to compare rates charged by various interexchange carriers have been substantially benefited by the relative simplicity of the existing rate structure.

538. In implementing price caps for AT&T, we have taken no action that would put geographic rate averaging at risk. AT&T's decision to geographically average its rates is based in part on the underlying costs of obtaining originating and terminating access at various locations around the country. In the access charge proceeding, we have initiated a series of gradual increases in the subcriber line charges, which recover a portion of common line costs through flat monthly charges on ratepayers. By the time price caps is implemented, monthly charges will have risen to their limit of $3.50. A subscriber line charge of $3.50 per month means that LECs need recover only a portion of common line costs from interexchange carriers. As a result, the access charges paid by AT&T and its competitors are much smaller

---

1142 See, e.g., Guidelines for Dominant Carriers' MTS Rates and Rate Structure Plans, Notice of Proposed Rulemaking, 100 FCC 2d 363, 375 (1985) and Memorandum Opinion and Order, FCC 85-540, released Oct. 17, 1985 (finding that geographic rate deaveraging would be unacceptable for MTS optional calling plans).

1143 See Section 1 of the Communications Act of 1934, 47 U.S.C. § 151.

than they were a few years ago.[1144] The price cap plan we adopt for AT&T does not alter existing common line cost recovery in any way.

539. In addition, any effort AT&T might make to deaverage its rates would have to be done in the context of a public tariff filing. Since our price cap plan does not streamline restructured tariff filings, a schedule reflecting deaveraged rates would be filed on 45 days' notice and would be subject to traditional justification and support requirements. Given our strong commitment to geographic rate averaging, however, we believe that any AT&T proposal to deaverage rates would raise significant issues affecting the achievement of the universal service goals embedded in the Communications Act. We therefore pledge that any AT&T tariff that proposes to deaverage rates will be subject to the full 90-day notice period provided under Section 203 of the Communications Act, and will be suspended for the full five-month period provided for under Section 204 of the Act. We also pledge to investigate any such filing by AT&T. In the course of such an investigation, AT&T would bear the burden of justifying its proposal, and, given our strong commitment to geographically averaged rates, the showing we will require will be difficult to meet. Thus, AT&T will face this Commission's fullest scrutiny, a lengthy public proceeding, and the likely participation of interested parties, should it elect to propose deaveraged rates.

540. Finally, AT&T itself states that deaveraging is not currently part of its regulatory agenda.[1145] This is fully consistent with our understanding of the incentives that AT&T has to keep its rates geographically averaged. As we stated in the Further Notice, the administrative burdens on AT&T to manage geographically deaveraged rates are not insubstantial.[1146] AT&T's competitors average rates, even though they are not compelled to do so.

541. We therefore conclude that implementation of price caps for AT&T does not place our geographic rate averaging policies at risk. We are confident that AT&T will make no attempts to geographically deaverage rates under existing policies. Any future decisions by this Commission that affect

---

1144 In May of 1984, the carrier common line (CCL) charge for both originating and terminating traffic was 5.24 cents per minute of use. By March of 1989, the terminating CCL charge had dropped to 3.39 cents per minute and the originating CCL charge was 0 cents per minute. But see MTS and WATS Market Structure, CC Docket No. 78-72, FCC 88-399, released Dec. 12, 1988 (requiring that the originating charge be set at one cent beginning April 1, 1989, with the balance recovered from the terminating charge).

1145 AT&T Comments at 7 n.*.

1146 Further Notice, 3 FCC Rcd at 3452 (paras. 484-85).

those policies will be given careful scrutiny to ensure that our universal service goals are met. And, if AT&T does elect to propose to deaverage its rates, its proposal will be met with the full measure of Commission scrutiny.

2. Market Rules and Implementing Regulations

a. Summary of Further Notice

542. In the Further Notice, we stated that we intended to retain existing policies and rules that foster competition and prevent discrimination in the provision of telecommunications services. We stated that these policies, including open entry, equal access, resale and shared use, interconnection, unbundling of tariffed services, and nonstructural safeguards for the joint provision of regulated and nonregulated activities, would continue to provide assurances of competition in the provision of telecommunications services.[1147] In addition, we stated that the regulations that implement these policies, including Open Network Architecture (ONA), Comparably Efficient Interconnection (CEI), and the joint cost rules would remain in effect, along with the separations rules and the Uniform System of Accounts (USOA).[1148]

b. Pleadings

543. With one exception, all parties commenting on this set of issues support the tentative conclusions of this Commission. Ohio PUC and API favor the retention of market rules and other requirements, including open entry, resale, interconnection, accounting safeguards, unbundling of tariffed offerings, ONA and CEI, separations rules, and the USOA.[1149] MCI agrees on the necessity of market rules, including the prohibition on resale restrictions, the requirement that services be generally available, and the prohibition on bundling of services, or services and equipment. MCI asserts that the enforcement of such market rules is extremely important to the continued growth of competition.[1150] AT&T supports the retention of Part 36.[1151] New Hampshire PUC suggests that the implementation of price cap regulation and ONA be staggered to ensure that POTS customers are not forced

---

1147 3 FCC Rcd at 3379 (para. 328).

1148 Id. at 3379-80 (para. 329) and 3462-63 (paras. 499-501).

1149 Ohio PUC Comments at 17-18; API Comments at 27.

1150 MCI Comments at 59.

1151 AT&T at 50 n.**.

to pay for features they do not want.[1152] Arkansas PSC argues that the separations manual, USOA, and joint cost rules are all designed for rate of return regulation. In addition, Arkansas PSC requests additional explanation of the effect of price cap regulation on ONA.[1153]

c. Discussion

544. We conclude that the implementation of price cap regulation will be enhanced by the continuation of existing market rules, implementing regulations such as ONA and the joint cost rules, and the USOA and separations rules. We believe that the introduction of both ONA and price caps will benefit all ratepayers, and we do not believe that it is necessary to take steps in this proceeding to "stagger" the implementation, as the New Hampshire PUC suggests. Indeed, we believe that price cap regulation, by fostering innovation and efficiency, may contribute to the rapid and salutary implementation of AT&T's ONA plan. Furthermore, our decision to implement incentive regulation for AT&T does not require overhaul of the separations rules, the USOA, or the joint cost rules. While these regulations were all initiated during a time when this Commission was regulating AT&T by means of rate of return regulation, the purposes they serve remain just as important and necessary under price caps. In fact, retention of these rules ensures that the implementation of price caps on the federal level does not disrupt state regulatory systems, since all of the foundational regulatory activities leading up to jurisdictional separations remain in place.

3. Complaint Procedures

545. In the Further Notice, we tentatively decided to retain our existing complaint procedures.[1154] Ohio PUC supports the retention of existing procedures in order to guard against abuse under price cap regulation.[1155] API, however, contends that existing complaint procedures involve considerable delays.[1156] In addition, IDCMA states that the statutory provisions for complaints do not specify the standards by which this Commission will judge complaints. IDCMA inquires whether a complainant will be required to show that AT&T's return on aggregate services exceeds its

---

1152 New Hampshire PUC Comments at 16-17.

1153 Arkansas PSC Comments at 2.

1154 3 FCC Rcd at 3380-81 (para. 332).

1155 Ohio PUC Comments at 17-18.

1156 API Comments at 28-29.

current rate of return.[1157] We affirm our tentative conclusion to retain existing complaint procedures. Prompt resolution of complaints will be assisted by the recent adoption of legislation requiring this Commission to resolve complaints within one year or, in certain cases, 15 months.[1158] The ultimate burden of proof continues to rest on the complainant.[1159] However, to the extent that facts reside exclusively within the knowledge of the defendant carrier, the carrier has the burden of going forward with that evidence.[1160] Once the carrier-defendant has met its burden of proving the facts within its knowledge, the ultimate burden of persuasion, as at present, must be carried by the complainant.

4. Interim Cost Allocation Manual

546. In the Further Notice, this Commission tentatively concluded that the Interim Cost Allocation Manual (ICAM) would be retained unless AT&T elects price cap regulation, in which case we proposed its use be discontinued.[1161] AT&T supports this Commission's tentative decision to discontinue use of the ICAM, and argues that the ICAM should be discontinued regardless of whether AT&T elects price caps. AT&T contends that the fully distributed cost methodology of the ICAM is arbitrary, wholly inconsistent with efficient pricing, and cannot measure earnings in any meaningful way.[1162] Ad Hoc and ICA contend that elimination of the ICAM will reduce reporting, and therefore reduce the data available to customers wishing to challenge AT&T's rates.[1163] Comptel argues that the ICAM is intended to prevent AT&T from abusing its market power, and should not be eliminated, because there is no proven substitute in price cap regulation.[1164]

547. We conclude that the ICAM should be discontinued. Since the ICAM requires fully distributed costing between broad service categories, its

---

1157 IDCMA Comments at 51-52.

1158 See Federal Communications Commission Authorization Act of 1987, P.L. 100-594 (signed Nov. 3, 1988).

1159 MCI Telecommunications Corp. v. AT&T, 85 FCC 2d 994, 999 (1981).

1160 Hughes Sports Network v. AT&T, 25 FCC 2d 550, 553 (1970).

1161 3 FCC Rcd at 3464 (para. 503).

1162 AT&T Comments at 49.

1163 Ad Hoc Reply at 19; ICA Comments, App. B (BRI Report) at 75-76.

1164 Comptel Comments at 26.

retention would be inconsistent with the price cap system we have devised and would interfere with the operation of the incentive structure. Furthermore, in its current form the ICAM does not reflect the division of services we have mandated as part of the price cap system.

5. Part 63 Rules

548. We tentatively concluded in the Further Notice that continued enforcement of the Part 63 rules concerning extension of lines and discontinuance of service would be desirable under price cap regulation.[1165] AT&T contends that the Part 63 rules are unnecessary because competition discourages the construction of unneeded facilities, and that this Commission should provide streamlined Part 63 treatment for AT&T.[1166] Pactel argues that to the extent that the provisions of Part 63 are designed to ensure prudent investment, they will be unnecessary under price cap regulation, and should be waived for carriers electing price cap regulation.[1167]

549. We conclude that we should continue to enforce the Part 63 rules under price caps. The Part 63 rules enable this Commission to determine whether particular facilities are inefficient or unnecessary, a determination that is part of our duty to safeguard the public interest. There is no evidence that the current approach is burdensome, and as continued application of Part 63 will provide an additional means of monitoring AT&T's behavior, we retain these rules.

6. Part 65 Rules

550. In the Further Notice, we tentatively concluded that we should retain our current Part 65 rules, but modify them for carriers electing price cap regulation. One of the modifications we proposed was a new annual rate of return report for AT&T.[1168] ICA and IDMCA state that this Commission should continue to monitor AT&T's rate of return during the initial period of price cap regulation.[1169] AT&T contends that its competitors should also be required to file annual rate of return reports, and that such a

---

1165 3 FCC Rcd at 3465 (para. 505).

1166 AT&T Comments at 50.

1167 Pactel Comments at 57.

1168 3 FCC Rcd at 3467-68 (paras. 509-10).

1169 ICA Comments at 21-22; IDCMA Comments at 52-53.

requirement would enable this Commission to better assess the performance of price cap regulation.[1170]

551. We conclude that our current Part 65 rules should be retained, with the modifications described below. AT&T will be excluded from Sections 65.703(a) and (f). In addition, we have added subsection (c) to Section 65.701 to extend to June 30, 1989 the final period of rate of return review for AT&T. New Section 65.703(g) provides a transitional refund mechanism for AT&T. Section 65.600(d) is a new section, requiring that AT&T file an annual report of its total interstate rate of return.[1171]

E. Monitoring and performance review

1. Summary of Further Notice

552. In the Further Notice, we tentatively concluded that a performance review of our price cap regulatory system would be necessary to protect against any unanticipated and unintended effects stemming from the design of our system or the construction of our formulas.[1172] We tentatively found, however, that carriers should first be given an opportunity to take advantage of the incentives that price cap regulation offers. We tentatively decided to initiate the performance review after three years of price cap regulation. We proposed that throughout the initial four-year period we would monitor the effects of price cap regulation through our review of tariffs and the collection of data.[1173] We tentatively concluded that the performance review will consist of a comprehensive examination of the price cap plan, including the level of prices, the achieved rate of return, quality of service, and technological progressiveness. We said that underachievement or overachievement with respect to these measures might result in adjustments to the overall level of price caps in future years.[1174] However, we tentatively concluded that the productivity factor should not be adjusted unless deviation from an acceptable level is substantial and persistent. Finally, we tentatively decided that exacting retroactive payments from

---

1170 AT&T Comments at 49.

1171 This proceeding concerns the regulation of dominant carriers, not of AT&T's competitors. The question of requiring interexchange carriers other than AT&T to file annual rate of return reports is therefore not one that can be addressed here.

1172 3 FCC Rcd at 3446-47 (paras. 471-72).

1173 Id. at 3446-47 (para. 472).

1174 Id. at 3447 (para. 473).

carriers would irreparably diminish the incentive to exceed an established target.[1175]

2. Pleadings

553. States, carriers, and users support the use of existing monitoring mechanisms. Carriers argue that the necessary mechanisms are in place.[1176] Parties state that these reporting requirements will supply data on prices, costs, and rates of return sufficient to properly assess carrier performance and the new regulatory approach.[1177]ited, CBT and New York DPS argue that more detailed monitoring information is unnecessary and would increase administrative costs.[1178] However, large users argue that this Commission's proposal for monitoring is inadequate,[1179] and Arkansas PSC requests further discussion of monitoring.[1180] Virginia states that it requires interexchange carriers to file quarterly reports that provide the information necessary to observe market shares, price behavior, the spread of competition, and equal access, and proposes that this Commission require similar reports.[1181] ICA recommends full implementation of ARMIS, with reports disaggregated to the basket level.[1182] API argues that this Commission should establish data reporting requirements before the implementation of price caps.[1183]

554. Parties generally support our proposal for a performance review at the end of three years after the inauguration of price cap regulation.[1184]

1175 Id. at 3447 (para. 474).

1176 US West Comments at 16; United Comments at 21; CBT Comments at 4.

1177 United Comments at 21; IDCMA Reply at 9; New Hampshire PUC Comments at 7; Alabama PSC Comments at 5; Colorado OCC Comments at 27; NY EnerTel Reply at 4.

1178 United Comments at 21; CBT Reply at 29; New York DPS Reply at 4.

1179 Ad Hoc Comments at 19; ICA Comments at 20-21; API Comments at 9.

1180 Arkansas PSC Comments at 4.

1181 Virginia Comments at 4.

1182 ICA Comments at 21-22.

1183 API Comments at 9.

1184 Alabama PSC Comments at 5; Illinois Comments at 29; Michigan PSC Comments at 26; Ohio PUC Comments at 4; BellSouth Comments, Appendix

Illinois argues that an earlier review would be inconclusive, and that adjustments made on the basis of an annual review would diminish incentives for efficient behavior, increase the costs of regulatory administration and compromise the long term benefits of price caps.[1185] In addition, New York DPS and Colorado OCC argue for periodic thorough performance reviews.[1186] Pactel, however, says that rate of return monitoring over the long term would be inconsistent with incentives to improve efficiency.[1187] Finally, Alabama PSC states that adjustments may be necessary before the end of the initial term of price cap regulation.[1188]

555. Some parties argue that this Commission must establish explicit criteria for the performance review.[1189] Indiana UCC proposes the establishment of a benchmark rate of return,[1190] and other parties request an explicit adjustment based on rate of return principles.[1191] However, Illinois argues that if the evaluation uses rate of return criteria, carriers will have incentives to act as they do under rate of return regulation.[1192] New York DPS and carriers contend that a statement by this Commission that a certain level of earnings will trigger regulatory intervention would seriously damage the incentive structure of price cap regulation.[1193] Illinois states that while earnings and rates are pertinent information, the review process must interpret these and other measures in a manner relevant to true consumer protection and compatible with the regulatory regime under review.[1194]

(statement of A. Kahn) at 2; Pactel Comments at 53; NTIA Comments at 4.

1185 Illinois Comments at 29-30. See also BellSouth Comments, Appendix (statement of A. Kahn) at 2.

1186 New York DPS Comments at 31; Colorado OCC Comments at 27.

1187 Pactel Comments at 53-54.

1188 Alabama PSC Comments at 5-6.

1189 CCIA Comments at 5; Illinois Comments at 30; Indiana UCC Comments at 28; Colorado OCC Comments at 23-24.

1190 Indiana UCC Comments at 28.

1191 Colorado OCC Comments at 27; Ad Hoc Comments, ETI Report at 3.

1192 Illinois Comments at 30.

1193 New York DPS Comments at 30; NYNEX Comments at 38 n.44; BellSouth Comments at 14.

1194 Illinois Comments at 30.

556. New York DPS argues that this Commission must state that if carriers earn excessive returns, the result will be adjustment and recalibration, and such recalibration will normally be expected to affect both cap levels and the productivity offset.[1195] CCIA and Illinois recommend that this Commission exercise care in adjusting the productivity factor as frequent adjustments may increase uncertainty as well as compromising incentives for efficiency.[1196] In addition, Illinois and CCIA, as well as New York DPS, oppose retroactive payments as undermining incentives for efficiency.[1197] However, Ad Hoc contends that consumers must be made whole for any losses suffered under price cap regulation.[1198] Finally, Ohio PUC recommends that, despite counter-incentives, this Commission should not rule out refunds if returns are unreasonably high, or actual productivity is much greater than 3 percent. Ohio PUC contends that carriers should not benefit at the expense of consumers merely because of the implementation of an experimental program.[1199]

3. Discussion

557. We adopt the tentative conclusions of the Further Notice with respect to monitoring and performance review. In embarking on a modified regulatory approach for AT&T, we run the risk that the regulatory controls that we have carefully crafted will produce unintended and unexpected results. Moreover, the type of regulation we are mandating, because it continually produces strong incentives for efficiency, is dynamic. The price cap formula we find reasonable today may become less so over time and may no longer help ensure that rates are just, reasonable, and nondiscriminatory. We therefore find that continual monitoring of AT&T's performance under price caps, and a comprehensive review of our regulatory structure, are both necessary and desirable.

558. We recognize that, to some extent, ongoing monitoring, as well as periodic review and adjustment of our price cap formula, may introduce the same incentives to pad investment that are present under rate of return.

1195 New York DPS Comments at 30-31.

1196 CCIA Comments at 6; Illinois Comments at 31.

1197 CCIA Comments at 5; Illinois Comments at 31; New York DPS Comments at 30.

1198 Ad Hoc Comments at 19-20.

1199 Ohio PUC Comments at 16-17.

Nevertheless, the dynamic nature of price cap regulation compels us to monitor and review our regulatory structure on a regular basis to ensure that the system continues to function in accordance with the requirements of the Act. We have carefully balanced these two concerns in selecting a time period for formal review of price cap regulation of AT&T. Our decision to monitor regularly and then formally review AT&T's performance during the fourth year of price caps reflects that balance. In the first four years of price caps, AT&T will have an opportunity, subject to ongoing monitoring, to implement efficiency-enhancing programs, and to begin to reap the benefits of those programs. In addition, we conclude that the formula is unlikely to produce rates outside the zone of reasonableness within the first four years.[1200]

559. During the initial four years of price cap regulation, we will monitor AT&T's performance, with particular attention to its prices, earnings, quality of service, and technological progressiveness. We find that information collections presently in place or planned will be sufficient to the task. ARMIS, the automated reporting system, is being implemented for AT&T, and will provide us with a consistent set of data starting January 1, 1988. At present, AT&T files ARMIS reports pursuant to our Form 901 Order that include information on revenues, expenses, investment, reserves, and taxes for purposes of tracking cost allocations between regulated and nonregulated activities; revenues and expenses by state and interstate jurisdictions; and switched messages, conversation minutes, and access minutes.[1201] In addition, we continue to require AT&T to file Form 492 on a total interstate basis, which contains information on revenues, investment, and expenses, and the earned rate of return. We will also continue to collect semi-annual reports on quality of service, and will continue to scrutinize the information AT&T files in connection with its annual Section 214 facilities authorization application.[1202] In addition, AT&T's tariff filings will provide information on AT&T's ability to stay within the no-suspension zone, and may indicate service quality changes if AT&T alters tariff terms or conditions. Our complaint processes can also provide us with important information on AT&T's performance.

1200 We will, however, monitor AT&T performance to determine if an earlier review is required.

1201 See Form 901 Order, 3 FCC Rcd 6261 at Appendix A. Current reporting for AT&T is based on ICAM categories, with data on private line services separated from data on services employing MTS and WATS. Since we have ended ICAM requirements in this Order, AT&T will no longer be required to report pursuant to ICAM categories. We delegate to the Bureau the task of redesigning reporting forms as necessary to accommodate the price cap system.

1202 We discuss our service quality monitoring plan in Section III.A.2, supra.

560. In addition to monitoring price cap regulation through the collection of data, our review of tariffs, and complaints, we will review AT&T's performance in a comprehensive manner at the end of the third year from the inaugural date of price cap regulation. We conclude that the timing of the performance review will avoid unacceptable deviations from the path of prices relative to costs, and will minimize the disincentives to efficiency presented by the prospects of an earlier performance review. Carriers that fear quick recapture of productivity gains will be less likely to make decisions that enhance their efficiency. Thus immediate or frequent performance reviews could result in a repetition of the flaws of rate of return regulation. We therefore schedule a performance review of the price cap plan for the end of the third year, to be completed before the end of the fourth year of price caps. Should it become apparent to us before this review that the price cap program is not achieving its goals, we will initiate an earlier review.

561. The performance review will consist of a comprehensive examination of the effects of price cap regulation, and will consider all available measures of market and carrier performance, including, but not limited to, actual prices, achieved rate of return, quality of service, and technological progressiveness. We require AT&T to report the costs and revenues associated with its excluded services separately from those associated with services subject to price caps, so that we may obtain a clear picture of AT&T's performance under our regulatory system. Underachievement or overachievement with respect to any measures of performance related to price cap regulation may result in changes to the productivity offset or other adjustments. We do not intend to adjust the productivity factor because of modest changes in the overall rate of return or any other measure, but we may undertake an adjustment if the deviation from an acceptable level is substantial and persistent. In any case, we will endeavor to ensure that the magnitude of the adjustment does not recreate disincentives to further productivity gains.

562. We wish to emphasize the seriousness of our resolve in undertaking these ongoing monitoring and review efforts. If it should be demonstrated to us that price caps are in fact resulting in unjust and unreasonable rates, we stand ready to take prompt remedial action.

IV. INCENTIVE REGULATION FOR LOCAL EXCHANGE CARRIERS

A. Introduction

563. In Section II of this Order, we find that incentive regulation is superior to, and will further the public interest more effectively than, rate of return with regard to the regulation of AT&T and the LECs. In Section III, we adopt a price cap plan for AT&T, one that is tailored specifically for the services AT&T offers to the public and the market environment in which those services are provided. In the instant Section, we start with the same "price cap" methodology that forms the basis for the AT&T plan and craft that

methodology into a plan for the LECs that accommodates the characteristics of the LECs' services and the market in which they are offered. These modifications are designed to ensure that implementation of price cap regulation for the LECs furthers the goals of the Communications Act and, in particular, results in just and reasonable rates for their interstate basic services.

564. The most important modification we are proposing for the LECs responds to the absence of the same level of corroboration for our average LEC productivity factor as we have for AT&T and to the possible variability in individual LEC productivity around the industry average. As a consequence, we propose to add a backstop that will serve as a check on the LECs' potential earnings, just as competition acts as a backstop on AT&T's potential earnings. The LEC backstop would be either a mechanism that would stabilize LEC earnings as part of the tariff review process or a detailed review of the LEC price cap cap system after a two-year period of operations under that system.

565. Before discussing the details of our proposal for implementing LEC price cap regulation, we first address the concerns expressed by state regulators, consumer groups, and large user groups about the effect of incentive regulation on service quality and state regulation. We then turn to the question of whether LECs should be able to elect to participate in the price cap plan. We then propose a timetable for introducing price cap regulation for LECs and for revising the initial filings. Next, we present the details of our proposed LEC price cap plan. Thereafter, we discuss the effect of the proposed plan upon existing Commission rules and policies. Finally, we discuss the performance review under our proposed plan.

B. Application of Incentive Regulation to LECs

1. State of competition for LEC services

a. Summary of Further Notice

566. In examining the state of competition for interexchange services and interexchange access services, the Further Notice drew two fundamental conclusions about the relationship of incentive regulation to competition -- (1) that incentive regulation and competition are complementary; and (2) that competition is a relevant consideration in making decisions about how to implement incentive regulation.[1203] We found that there is less competition for LEC access services than for interexchange services. Nevertheless, we found that the development of shared tenant systems, private networks, and other technologies suggests that competition for access services is

---

1203 Further Notice, 3 FCC Rcd at 3267 (para. 138).

increasing.[1204] While the level of competition is not as substantial or as pervasive as in the interexchange market, evidence also suggests that the long run prospects for competition for LEC services are significant.[1205]

b. Pleadings

567. Comments concerning the application of incentive regulation to the LECs generally are divided into two camps. Those advocating incentive regulation for LECs argue that there is greater need to adopt price caps for LECs than for AT&T because the relative absence of competition for access services presents a stronger case for the elimination of a regulatory system that contributes to rate base padding and other inefficiencies.[1206] Those opposing incentive regulation for the LECs argue that adoption of incentive regulation in the absence of competition will foster unreasonable rates, discrimination, and anticompetitive activities.[1207]

568. Parties generally agree that competition for LEC services does not currently exist.[1208] There is some dispute over when, if ever, competition for LEC services is likely to develop. Some LECs argue that they are already subject to competition in some areas for some services.[1209] Other parties

---

1204 Id. at 3270 (para. 147).

1205 Id.

1206 PRTC Comments at 4-5 (incentive regulation should be applied to LECs first to prevent uneconomic bypass of LEC facilities); SWB Comments at 15 (arguing that the competition to which AT&T is subject has already improved AT&T's ability to operate more efficiently). See also Rochester Comments at 2 (price caps for LECs will improve efficiency, foster innovation, permit needed pricing flexibility, and alleviate administrative burdens); USTA Reply at 4-5.

1207 See, e.g., MCI Comments at 22-25; Maryland PC Reply at 7-8; API Reply at 13-14; Florida PSC Reply 3-4.

1208 NTN Comments at 32-33 (bypass is nonexistent); Comptel Comments at 10-11; New Hampshire PUC Comments at 4 (interstate access and local service are monopoly services); MCI Comments at 2; Maryland PC Comments at 3 (disagrees that caps will encourage competition for LEC services); Nevada Comments at 3; IDCMA Comments at 37-38 (competition for LEC services not likely to develop soon); API Reply 17-18; ICC Reply at 2; NARUC Reply at 5 (arguing that we should proceed to adopt incentive regulation only for AT&T); Texas PUC Reply at 6; NTN Reply at 7; SWB Comments at 21.

1209 Bell Atlantic Comments at 19-20 (arguing that ICC serves as an alternative access provider in Washington, D.C., and three alternative access

argue that effective competition to LEC services is not likely to develop in the near future.[1210] Some parties state that the existence of competition is not a prerequisite for the application of incentive regulation to dominant carriers and therefore the absence of competition is not determinative of whether incentive regulation should be applied to LECs.[1211]

569. Proponents of incentive regulation for LECs make several different arguments about why price cap regulation makes sense for LECs. CCIA argues that since access represents about half of the cost of an interLATA call, LECs ought to be included in a price cap program if consumers are to reap the full benefits of regulatory reform.[1212] BellSouth argues that price cap regulation represents a better form of regulation for LECs because it does not require the use of Part 69 to allocate costs among rate elements, a regulatory requirement BellSouth states is based on an inherently arbitrary fully distributed costing system.[1213] According to BellSouth, use of price caps for LECs also is essential if this Commission wishes to create a "level playing field" for the development of competitive access services.[1214] CBT, which assumes that LECs are already subject to competition, states that the

---

suppliers compete with Bell Atlantic in Philadelphia, Pennsylvania); Rochester Comments at 4; Pactel Comments at 32; SWB Comments at 24; Ameritech Comments at 14; SNET Reply at 10; GTOC Reply at 18-19. See also CCIA Comments at 7 (LECs are subject to competition for large users).

1210 ICC Comments at 3-4 (arguing that substantial barriers to entry remain in its bid to compete with Bell Atlantic for the provision of interstate access). See also ICC Reply at 2-4; New Hampshire PUC Comments at 14-16 (bypass of LEC facilities is limited to large users only); AT&T Comments at 8-9 (monopoly power of the LECs presents different implementation issues).

1211 US West Comments at 7; SNET Comments at 7; NTIA Comments at 2 (price cap regulation is a surrogate for competition); Illinois Comments at 17-20 (competition should nevertheless play a role in determining the degree of flexibility granted under an incentive-based system); Ad Hoc Comments at 10 (absence of competition ought to compel a different incentive-based structure).

1212 CCIA Comments at 6. Accord SWB Reply at 12. See also NYNEX Comments at 9 (arguing in favor of simultaneous implementation of price caps for AT&T and the LECs).

1213 BellSouth Reply at 5-6.

1214 Id. at 6-7.

pricing flexibility afforded by a price cap system is important if LECs are to be able to react to competitive pressures.[1215]

570. Most of those opposing price caps for LECs argue that an incentive-based system is inconsistent with the absence of competition and will result in unlawful pricing.[1216] Several parties argue that price caps permit carriers to pursue improper pricing strategies, while reducing the level of regulatory oversight.[1217] Some parties argue that the LECs could employ their monopoly power to thwart interexchange competition, until the BOCs themselves are free to provide interexchange service.[1218] Commenters state that price cap regulation for LECs should be deferred, or modified from the AT&T proposal, so as not to interfere with interexchange competition.[1219] Cable & Wireless states that price cap regulation is transitional by nature and cannot be employed in a monopoly setting that requires long term regulation.[1220]

1215 CBT Comments at 3.

1216 Additional comments concerning the mechanics of the proposed price cap system, and its effect on rates, are addressed in the context of LEC baskets and bands, infra.

1217 MCI Comments at 6, 22-25; Maryland PC Comments at 3-4; Nevada Comments at 3; Missouri Comments at 3-4; MCI Reply at 8-9; Maryland PC Reply at 7-8. MCI argues that the LECs have already demonstrated a willingness to price improperly, citing various examples of LEC tariffs that this Commission has rejected as improper. MCI Comments at 34-36. Comptel states that under price caps, this Commission will lack the necessary tools to prevent abuses of market power. Comptel Comments at 10-11. But see BellSouth Reply at 18-19 (arguments about LECs employing their monopoly power to cross subsidize various services are misplaced because a properly designed price cap system eliminates incentives to cross subsidize).

1218 MCI Comments at 30-34; Comptel Comments at 12-13.

1219 ICC Comments at 5; NTN Reply at 6; TCA Comments at 6 (a voluntary plan should not be applied to LECs until additional ratepayer protections are built into it). See also Florida PSC Reply at 4-5 (price caps for LECs should provide a stimulus for cost reductions and innovation, but not permit maximization of profits).

1220 Cable & Wireless Comments at 4-7 (arguing that due to unforeseeable economic changes, no price cap formula can ever be expected to perform as intended in the long term). See also New Hampshire PUC Comments at 7 (this Commission should consider retaining rate of return for LECs); Executive Agencies Comments at 7 (evolution toward deregulation of LECs is unlikely in the near future).

571. In addition to concerns about discrimination and unlawful cross-subsidization, commenters also question whether a price cap system for LECs will generate efficiency and innovation in LEC services. MCI argues that because LECs are monopolists, the Averch-Johnson effect will persist under price caps, since this Commission must periodically review the formulas and carrier rates and costs.[1221] Furthermore, MCI states that the LECs have not been able to quantify the efficiency effects of price caps.[1222] MCI also argues that no new LEC access services are likely to arise from a price cap system of regulation.[1223] Missouri argues that the conclusion that LECs will become more efficient under price cap regulation is untested.[1224]

c. Discussion

572. Commenting parties generally agree with our tentative finding that there is little competition for LEC access services. Even those who argue that some competition currently exists acknowledge that there is only limited competition for certain LEC services. The debate instead centers around whether the limited nature of competition for LEC services makes a price cap system unworkable or undesireable.

573. We reaffirm our tentative conclusion in the Further Notice that competition is not a prerequisite for price caps. Price cap regulation is designed as a substitute for rate of return regulation, and is intended to be applied to dominant carriers' services. By definition, therefore, price cap regulation is intended as an alternative method of constraining market power. Provided that the price cap system is designed correctly, there is no basis for finding that a regulatory regime designed to constrain market power can be used only in the presence of competition of the kind that AT&T currently faces. Indeed, even for carriers that face no competition, price cap regulation can lead to increased efficiencies in regulated operations through the incentives it creates. Ratepayers will then be able to share in the efficiencies generated by the incentive-based system.

574. Of course, we recognize that since the LECs are subject to less competition than is AT&T, and provide different services than AT&T, our price

---

1221 MCI Comments at 26-27.

1222 Id. at 5-6.

1223 Id. at 5; MCI Reply at 9-10.

1224 Missouri Comments at 4.

cap plan may reflect these differences between the two. The following sections of this Second Further Notice of Proposed Rulemaking describe in detail how we propose to modify the price cap plan for the LECs. For example, to remedy the absence of full information about post-divestiture LEC productivity and how productivity differs between LECs, we are proposing to apply an adjustment mechanism to LEC prices that will maintain LEC earnings within a range designed to keep prices just and reasonable. Although competition for LEC services is not sufficiently developed to act as a "backstop" in the event price caps produced unintended results, the adjustment mechanism we have designed -- known as the "automatic stabilizer" -- will serve the same function in a LEC price cap system as does competition in the regulatory system we adopt for AT&T. Thus, our proposal for LECs recognizes and applies the principle we cited in discussing the effect of competition on an AT&T price cap plan, i.e., that the state of competition for dominant carrier services must play a role in shaping the regulatory structure we employ. Price cap regulation is not, therefore, a regulatory mechanism that can only be applied in an environment that has already made substantial progress in the transition to full competition, as some commenters suggest.

575. We tentatively reject arguments that price cap regulation for LECs will not generate the benefits we associate with incentive regulation of dominant carriers generally. Just as in the case of AT&T, price caps will reverse the tendency of LECs to engage in rate base padding or to include unnecessary expenses in their annual revenue requirements. The incentive structure we propose to create does not depend upon the existence of competition. We recognize, as we did with AT&T, that periodic reviews of the price cap system means that we will not completely defeat the effects of the Averch-Johnson principle. Nevertheless, we believe that the incentive-based system we are adopting will ameliorate it substantially. Price caps should also encourage innovation. We recognize that at present this Commission prescribes the structure of LEC switched access services, and that our prescription effectively prevents LECs from introducing new switched access services without a waiver of our rules.[1225] As a result, the LECs are in a different posture than AT&T, since AT&T may introduce new services by filing a tariff. Nevertheless, we believe that price caps will spur LECs to innovate in the ways in which they provide the prescribed services, and that these innovations will produce cost savings that can be passed on to consumers. Finally, we tentatively conclude that price cap regulation for LECs will also foster pricing efficiencies and lessen administrative burdens, as we concluded price caps would for dominant carriers generally.

576. Although we believe that substantial benefits will flow from adopting incentive regulation for LECs, we are not applying a price cap system to LECs prior to, or simultaneously with, AT&T. As we will discuss in later

---

1225 See Part 69 of this Commission's Rules, 47 C.F.R. §§ 69.1 et seq.

sections of this Notice, the application of a price cap system to access services presents certain technical difficulties not present in the case of AT&T. While we remain committed to replacing the current regulatory system, which we have found to contain certain flaws, we do not intend to delay the benefits a price cap system would generate if applied to AT&T while these problems are resolved. Our intent is to move expeditiously toward adopting a workable price cap system for LECs, recognizing that the full benefits of such a system will not accrue to ratepayers until both AT&T and the LECs are subject to regulatory reform.

577. Our tentative decision that price caps will be an effective means of regulating LECs is not wholly unrelated to the effects of competition, however. We believe that while the existing market for access services is marked by little competition, additional competition will develop in the future. Teleports, shared tenant systems, cellular radio, and alternative access providers already provide users with a different means to access interexchange facilities. Alternative access technology therefore already exists. If historical patterns in the provision of telecommunications hold true, these alternative access technologies will gradually decline in cost. It is quite possible that the future holds significant competition in the provision of LEC access services. Given that the LECs may be subject to additional competition in the future, there is a clear benefit to adopting a regulatory structure that will accommodate future competition. As we have discussed in our treatment of incentive regulation for AT&T, price caps are far better suited to an environment of emerging competition than is rate of return.[1226]

578. Those who argue that price cap regulation will create opportunities for LECs to discriminate unlawfully or engage in cross-subsidization are in effect arguing that the combination of baskets and bands that we have proposed for LECs will not protect ratepayers from unlawful pricing policies. As we discuss infra, we believe that the baskets and bands we propose herein represent an effective balancing of ratepayer and carrier interests, and ensure that the correct incentive structure is created. In crafting our proposal for the LECs, we agree with those parties who argue that price cap regulation must be tailored to the LECs and their unique positions as providers of access services. In the ensuing sections, we describe modifications to our proposed price cap plan for LECs.

2. Service Quality

a. Summary of Further Notice

1226 See Section III.A.1, supra.

579. In the Further Notice, we tentatively concluded that price cap regulation would not adversely affect LEC service quality. We identified several forces constraining a LEC's ability to secure higher profits through degradation of service. We said that quality cutbacks could cause increased call blocking and more down-time, leading to reduced numbers of completed calls and reduced revenues.[1227] Quality reductions would also manifest themselves readily and invite a rapid response from customers -- primarily the interexchange carriers for interstate access -- and regulators.[1228] We also tentatively found that this Commission's current monitoring efforts would detect any decline in service quality.[1229]

580. We tentatively concluded that our existing monitoring of LEC service quality would serve as an adequate check on the LECs' ability to degrade their networks. Exchange carrier quality of service monitoring presently consists of: (1) semi-annual BOC quality of service reports;[1230] (2) scrutiny of changes in technical standards as part of the tariff review process under Part 61 of our Rules;[1231] (3) the complaint process;[1232] and (4) review of annual reports on national security emergency preparedness (NSEP). We sought comment on whether additional measures were necessary. In particular, we asked whether it would be in the public interest to incorporate into our rules standards such as NARUC's 1987 Model Telecommunications Service Rules for LECs, and if so, how this should be done.[1233]

1227 Further Notice, 3 FCC Rcd at 3265 (para. 134).

1228 Id. at 3265-66 (para. 135).

1229 Id. at 3266 (para. 136).

1230 These reporting requirements were imposed in the Section 214 Divestiture Order, 96 FCC 2d at 76-84, 92. The RBOC reports filed to comply with that Order cover: (1) customer satisfaction levels, disaggregated into residence, small business, and large business subcategories; (2) percent of switching machines performing at or above dial tone speed objectives; (3) percent of offices meeting all transmission objectives; (4) percent of calls encountering equipment failure or blocking; and (5) percent of "on time" responses to service orders.

1231 47 C.F.R. §§ 61.1 et seq.

1232 47 U.S.C. § 208.

1233 Further Notice, 3 FCC Rcd at 3459 (para. 495) & n.1000.

b. Pleadings

581. Our tentative conclusions on the relationship between price caps and quality of LEC services provoked much comment, but no consensus. Commenters disagree on the extent to which price cap regulation would affect service quality.[1234] Likewise, there is no agreement over whether this Commission's existing monitoring activity is sufficient to detect and prevent or to remedy declines in LEC service quality. Finally, there is no consensus among commenters over whether additional monitoring or quality of service standards are needed for LECs.

582. LECs generally state that service quality is unlikely to decline under price cap regulation.[1235] A number of LECs note that customers for interstate access services are primarily interexchange carriers such as AT&T and MCI, sophisticated users fully capable of detecting service quality degradation and of using this Commission's complaint process to protect themselves against such degradation.[1236] Rochester and NYNEX note that any decline in service quality in interstate access service could lead to facilities bypass by large users such as interexchange carriers.[1237] MCI, on the other hand, states that LECs may have an incentive to reduce quality for an existing service while creating a new "improved quality" service for which they would be able to charge a premium.[1238] MCI also is concerned that customers may not respond to gradual service degradation because customers may be willing to tolerate reduced quality as long as the value to them of the reduced quality service is greater than the transactional costs of switching suppliers. It adds that "in monopoly LEC markets, this differential could be large."[1239]

1234 See also Section II.A.2, supra, for additional discussion of commenter positions on service quality that apply to both AT&T and the LECs.

1235 See, e.g., Ameritech Comments at 44-47; Ameritech Reply at 58; BellSouth Comments at 19; Rochester Reply at 5; Pactel Reply at 21; SWB Reply at 36; Centel Comments at 15; GTOC Comments at 8-10.

1236 See, e.g., BellSouth Reply at 15-16; NYNEX Reply at 54-55; Centel Reply at 17; Rochester Reply at 6.

1237 Rochester Reply at 6; NYNEX Reply at 55. See also USTA Reply at 8 (it is "not technically feasible for exchange carriers to selectively reduce quality for customers with few alternatives, while maintaining higher quality for customers who have the capability to take advantage of competitive alternatives.").

1238 MCI Comments at 49-50.

1239 Id. at 46.

583. Several commenters state that price caps would create an incentive to increase profits by deferring maintenance and investment, which, in turn, would lead to "creeping dilapidation" of the network.[1240] UCC, for example, states that "[t]he opportunity to retain unlimited profits under price cap regulation will create a new incentive to reduce necessary as well as unnecessary costs."[1241] Ameritech disagrees with this assessment, however, noting that service quality did not decline under a Michigan "CPI-adjustment plan" that resembled price caps.[1242] Likewise, Pactel states that price caps are not inconsistent with reliable service because it would be counterproductive to forego routine maintenance. According to Pactel, foregoing such maintenance would result in long run costs unrecoverable under price caps.[1243] Indeed, Pactel argues that price caps provide incentives to invest in new technology, like ISDN and SS7, that will promote cost savings and efficiencies.[1244] Other LECs assert that the revenue generated by traffic sensitive charges, gives LECs an enormous incentive to reduce call blockage in order to complete as many calls as possible.[1245]

584. A number of commenters point to the decline in British Telecom's service quality after price cap regulation was adopted in the United Kingdom as evidence of what they argue is the incentive price cap regulation creates to increase profits at the expense of service quality.[1246] As discussed more fully in connection with our treatment of AT&T service quality, supra, British Telecom contends that its service quality problems were not caused by price cap regulation.[1247]

1240 See, e.g., Florida's Citizens Reply at 10; Cable & Wireless Comments at 18. See also Michigan PSC Comments at 10; MCI Comments at 44; NARUC Reply at 16.

1241 UCC Reply at 5. See also DC PSC Comments at 7; ALC Comments at 26; ICA Comments at 27.

1242 Ameritech Reply at 59.

1243 Pactel Reply at 21.

1244 Id.

1245 See, e.g., NYNEX Reply at 21.

1246 See, e.g., MCI Comments at 44, 50; NARUC Reply at 17; CFA Reply at 6; Arinc Reply at 2; UCC Reply at 5; DC PSC Comments at 4.

1247 British Telecom Comments at 7.

585. Opinions differ regarding whether this Commission should establish specific service quality standards. Pactel states that because service standards are incorporated in tariffs there is no need for additional standards.[1248] Ameritech notes that most states already have service quality standards and concludes that this eliminates service quality as an issue in those states.[1249] Likewise, US West sees no need for additional formal action on standards.[1250] Most state commenters, however, advocate new specific standards for monitoring service quality. The Ohio PUC, for example, states that price caps should not be implemented until new monitoring standards are developed or, failing that, new monitoring standards should be established early in the initial three-year test period.[1251] NARUC states that this Commission's limited staff cannot monitor the entire LEC industry, especially without specific standards.[1252] Proposals for third-party testing for central office and outside plant receive support from a number of state commissions.[1253] Some commenters also support releasing to the news media service quality reports similar to Federal Aviation Administration airline "on-time" performance reports.[1254]

586. Several parties emphasize a need for coordination of state and federal service quality programs for LECs. Ameritech, for example, states that federal service quality standards are "a reasonable compromise if (1) the standards do not create a conflict with existing state standards; and, (2) service quality standards are applied to interexchange carriers as well

---

1248 Pactel Reply at 22. See also NYNEX Reply at 54.

1249 Ameritech Reply at 62. Ameritech notes that each of the states in its region has service quality standards including: (1) dial tone speed; (2) transmission loss and noise levels; (3) blocking levels; (4) installation and repair intervals; and (5) customer trouble report levels. Id. at 61.

1250 US West Reply at 38.

1251 Ohio PUC Reply at 4.

1252 NARUC Reply at 22. See also id. at 19 ("[K]ey to effective quality regulation is the presence of approved standards, coupled with an active monitoring compliance program."); Ohio PUC Reply at 3; New York DPS Comments at 33-37; DC PSC Comments at 2-9; Michigan PSC Comments at 10-12; CFA Reply at 6.

1253 See, e.g., Missouri PSC Comments at 10; Michigan PSC Comments at 10. See also Florida's Citizens Reply at 11.

1254 See, e.g., New York DPS Comments at 34; NY EnerTel Reply at 8.

as LECs."[1255] Ameritech identifies two options for assuring consistency between federal and state standards. First, this Commission could incorporate by reference state quality of service standards, where such standards have been adopted for local exchange carriers. In states without such standards this Commission could adopt and apply model standards. Second, this Commission could convene a Joint Board to establish nationwide service quality standards that would preempt state standards.[1256] In Ameritech's view, the latter option is not warranted at this time.

587. A number of states propose that new service quality standards be set by this Commission and the states jointly,[1257] while others propose that this Commission establish a task force with representatives from each of the 50 states plus the District of Columbia to set such joint standards.[1258] Still others suggest states not already having service quality standards might want to adopt NARUC's 1987 "Model Telecommunications Service Rules."[1259] US West, however, noting that none of the states in its region uses the NARUC Model, concludes that it "seems entirely inappropriate to attempt to secure the adoption of something like the Model Rules through a federal docket on price caps."[1260] The New York DPS notes that most of the service quality indicators on which the BOCs report to this Commission represent aspects of service quality that primarily affect intrastate communications and that are regulated by many states. New York DPS takes the position that, absent a clear demonstration that the states are not doing an effective job at such regulation, to the detriment of interstate telecommunications, imposition of federal standards is unwarranted and could improperly interfere with the respective states' regulation of intrastate services.[1261]

1255 Ameritech Reply at 60-61.

1256 Id. at 62.

1257 See, e.g., Ohio PUC Reply at 4; DC PSC Comments at 8.

1258 See, e.g., Oregon PUC Reply at 4; Michigan PSC Comments at 12.

1259 See, e.g., DC PSC Comments at 8; NARUC Reply at 19.

1260 US West Reply at 40.

1261 New York DPS Comments at 32. But see NARUC Reply, App. E, "Telephone Service Quality Under Price Caps" at 2, 5 (arguing that federal quality standards are necessary, since state quality of service monitoring is inconsistent from state to state, focuses on voice grade services, and is nonexistent in some states).

588. Comments also reflect substantial disagreement on the efficacy of this Commission's service quality monitoring program. LEC commenters generally agree with the tentative conclusion reached in the Further Notice that this Commission's existing monitoring and enforcement procedures are sufficient to ensure service quality.[1262] Pactel notes that state monitoring of local service quality provides an additional check against service quality degradation, because the same facilities are used for intrastate and interstate service.[1263] Other commenters, however, argue that this Commission's monitoring program is inadequate[1264] and unable to detect gradual declines in quality.[1265] UCC contends that this Commission's method of monitoring allows losses and improvements to offset each other and thus go undetected.[1266] UCC also finds this Commission's requirements lacking because they do not apply to non-BOC LECs[1267] and do not include information about routine maintenance or plant modernization.[1268] The Michigan PSC states that special attention must be given to monitoring service quality in rural areas to prevent LECs from neglecting those areas in favor of urban areas.[1269]

1262 See, e.g., Rochester Reply at 6; NYNEX Reply at 53; US West Reply at 38; CBT Reply at 28; Centel Reply at 14.

1263 Pactel Reply at 23. See also CBT Reply at 28; Centel Reply at 14-15.

1264 See, e.g., Ohio PUC Reply at 3; CFA Reply at 6; Cable & Wireless Comments at 20; DC PSC Comments at 7; New York DPS Comments at 34; MCI Comments at 46 n.70 ("The extent to which the Commission actually monitors performance of the LECs' interstate access networks is open to question. Complaints raised more than three years ago . . . have never been satisfactorily resolved.") NARUC Reply, App. E "Telephone Service Quality Under Price Caps" at 5 (arguing that federal monitoring is too aggregated to pick up localized service quality problems).

1265 See, e.g., NARUC Reply at 22; Michigan PSC Comments at 11; UCC Reply at 8 (Commission monitoring inadequate to detect deferred maintenance).

1266 UCC Reply at 9.

1267 Id.

1268 Id. at 11.

1269 Michigan PSC Comments at 11. See also NARUC Reply, App. E, "Telephone Service Quality Under Price Caps" at 4 (stating that carriers are likely to engage in selective service quality reductions in areas where customers and revenues will not drop).

589. BellSouth and Rochester propose plans for monitoring service quality for interstate switched access and special access services.[1270] These plans call for this Commission to require LECs to file quarterly reports on four aspects of service quality: installation quality, repair quality, network quality, and customer satisfaction. The BellSouth and Rochester proposals, which are similar, would define and measure each dimension of service quality as follows:

1. Installation Interval -- Percent of Time Quoted Interval Date is Met

   Definition: The percent of time the company providing the service is able to complete the work within the installation interval quoted to the customer.

   Method of Measurement:

   Calculate a percentage, based on the total number of service installations that were completed within the installation interval quoted to the customer, excluding the time the customer fails to provide necessary access to its premises, during a given quarter, divided by the total number of installation intervals quoted.

2. Repair Interval -- Absolute Time

   Definition: The total number of hours necessary to complete a customer's request for repair of interstate switched access or special access service.

   Method of Measurement:

   This is to be calculated from the time the company receives a customer's repair complaint (service affecting and non-service affecting) to the time the repair has been completed by the company, excluding the time the customer fails to provide necessary access to its premises. Within any given quarter, develop an average, based on the total number of customer repair

---

1270 BellSouth Reply at Att. B, "Service Quality Monitoring Proposal for Interstate Switched Access & Special Access Services"; Rochester Reply at App. A "Service Quality Monitoring for Interstate Switched Access and Special Access Services". These plans have been endorsed by USTA on behalf of its member LECs. See USTA Letter to Chairman, FCC, Oct. 28, 1988.

complaints received and subsequently repaired or resolved during that particular quarter.

3. Network Blockage Percentage

Definition: The average blocking level to which a trunk group is engineered.

For Feature Group A and B no design blocking criteria apply.

For Feature Group C and D, LECs generally designate the trunk group to either B.005 or B.010 blocking in accordance with Section 6.5.7 of F.C.C. Tariff No. 1. The Tariff Measured Blocking Thresholds, which are tolerance ranges of blockage, range from 2 percent to 14 percent and are dependent upon the size of the trunk group, the number of days of valid data in the study period, and the Design Blocking Objective for the trunk group.

Method of Measurement:

A measurement of the percentage of total offered calls that receive a no circuit (NC) condition. Blocking is the ratio of blocked attempts to total attempts within an hour time interval. Mathematically, blocking is (O/PC)*100, where O (Overflow) equals blocked attempts, and PC (Peg Count) equals total attempts.

Blocking on a trunk group is averaged for engineering purposes. Average Blocking is an average of the blocking level over a study period using Time Consistent Busy Hour, which is the identical hour each day during which, over a number of days, the highest average traffic load is measured.

4. Formal FCC Complaints per 1,000 Access Lines

Definition: Customers not receiving service satisfaction by dealing directly with their service supplier have the ability to send their specific complaint in writing to this Commission. The service supplier would be required to provide this Commision a written response to the formal complaint explaining the situation.

Method of Measurement:

> Establish the total number of written complaints received for each company per 1,000 access lines during any given quarter and develop a trend by which the company is measured.[1271]

590. BellSouth and Rochester state that the measures they propose would provide early warning of service quality deficiencies by allowing this Commission to track trends and to spot carriers whose quality performance differs markedly from that of others. They suggest that, where available, data for the four quarters preceding price caps be collected; otherwise, they say, the first few quarters of data collected under price caps can serve as a benchmark.

591. Several commenters suggest that this Commission "prescribe ... mechanisms to compensate users for carrier failures to meet installation dates and service quality/restoration requirements ...."[1272] British Telecom is instituting such a compensation plan in April 1989.[1273] US West opposes a compensation plan similar to British Telecom's because it seems to be substituting "individual customer tort/contract liability" for "'service quality' as a network degradation issue."[1274] US West asserts that today "individual customer claims are 'handled on an individual company/customer basis through contract', where the contractual vehicle is the tariff."[1275] Unlike the British Telecom plan, however, the contractual liability of US West operating companies is limited by the tariff. US West adds that "it remains a viable theory that the general body of ratepayers, i.e., the users of the 'network', [should] not be asked to 'insure' for any individual customer a certain guaranteed behavior."[1276]

592. Parties also discuss the possible impact on service quality of our proposals for new and restructured services. ICA and API argue that carriers might intentionally degrade the quality of an existing service in order to

---

1271 Rochester Reply, App. A at 2-3.

1272 Arinc Reply at 3. See also New York DPS Comments at 36.

1273 British Telecom Comments at 3 (British Telecom will pay "individual customers a fixed compensatory payment if it fails to provide network installation and repair service within the specified time.").

1274 US West Reply at 41.

1275 Id. at 42 (emphasis in original).

1276 Id.

force customers to migrate to a new service offered outside price cap constraints.[1277] Bell Atlantic counters that any such strategy by carriers would likely involve non-streamlined tariff restructuring, and that carriers cannot unilaterally abandon service quality provisions in their tariffs.[1278]

c. Discussion

593. We begin our discussion of these comments by emphasizing that this Commission is committed to ensuring that LECs continue to offer high quality services to every class of customer. As discussed above in Section III, we do not believe that incentive regulation necessarily leads to degradation of service quality. With respect to the effects of price caps on LEC service quality, we find strong evidence that price caps will not adversely affect the quality of the LECs' interstate services.

594. First, the LECs' primary customers for interstate access are large, sophisticated interexchange carriers. Such customers possess the technical expertise and the incentive to use that expertise to uncover any decline in service quality. Upon detecting such decline, these users also are likely to call upon their considerable legal resources to pursue complaints at this Commission and state commissions. Such interexchange carriers function effectively as large, sophisticated, expert surrogates for small individual users.

595. Second, because revenue for interstate access is largely usage sensitive, LECs have significant incentives to prevent declines in service quality that might lead to call blockage. Admittedly these incentives do not apply to all dimensions of service quality. Nevertheless, because of the interdependent nature of the network, increasing capacity in order to prevent blocked calls will also have positive effects on other elements of service quality.

596. Third, the facilities used to provide interstate access service are the same facilities that the LECs use to provide intrastate services. Since many states have specific service quality standards and monitoring programs complementing our programs, it is unlikely that a LEC could degrade service quality without detection. For these reasons, we do not propose to adopt specific service quality standards, nor do we propose to adopt the type of compensation scheme to which British Telecom is subject.

597. We are nevertheless concerned that this Commission be able to ensure that service quality does not deteriorate from the levels attained

---

1277 ICA Comments at 31; API Comments at 30-31.

1278 Bell Atlantic Comments at 6.

under rate of return once price cap regulation is implemented. While there appear to be sufficient forces pressing the LECs toward maintenance of high quality service, we believe that maintenance of the status quo could best be achieved through a monitoring program that requires all price cap carriers to file service quality data in a reporting format that is susceptible to benchmark comparisons.

598. Our interest in monitoring LEC service quality stems from the concerns expressed by state commissions and other commenters about the possible impact of price caps on LEC service quality. Both to allay those concerns, and to provide ourselves with data to assist our evaluation of our price caps program, we propose to expand our monitoring of LEC quality of service for those carriers subject to price cap regulation.

599. The comments suggest several possible monitoring mechanisms. We could retain the service quality reports currently required of the BOCs, and extend that reporting requirement to the other price cap LECs. We could adopt a new reporting requirement along the lines suggested by BellSouth and Rochester. Or, as an alternative to a reporting requirement of our own, we could require carriers to submit to us copies of any service quality reports they submit to state commissions. We tentatively conclude that, of these three options, the BellSouth/Rochester approach is preferable because it is the one most likely to produce data which can be used for benchmark comparisons as well as for tracking the progress of each individual LEC.[1279] We therefore propose to require that all price cap carriers file service quality information in the form suggested by BellSouth/Rochester. The BOCs would also continue to submit their existing service quality reports, and we propose to delegate to the Common Carrier Bureau the task of modifying the existing reports to eliminate unnecessary duplication.

600. We further tentatively conclude that the public interest might best be served by adding to the BellSouth/Rochester plan several additional reporting categories. These categories might cover the following aspects of interstate access service quality: post-dial delay, transmission quality, switch downtime. The service quality reporting categories we apply to AT&T might also be useful in evaluating LEC performance. We seek comment on these proposed reporting categories and on other reporting categories which might be used to monitor the quality of service provided by LECs.

1279 Some of the data currently collected in the BOC service quality reports is in a form which does not facilitate inter-company comparisons. For example, transmission quality is reported as the percentage of a company's offices which meet the company's own standards for transmission quality. Reliance on service quality reports required by various states would produce disparate data, or, for carriers operating only in states which lack service quality reporting systems, no data at all.

601. Parties commenting on our monitoring proposal, or proposing new reporting categories, should focus on the definition of each element of service quality that is to be monitored. For example, the BellSouth/Rochester proposal would define installation intervals in terms of the percentage of time the carrier completed work within the installation interval quoted to the customer. It might be preferable, however, to define this aspect of quality in terms of specified installation intervals, so that companies might report the percentage of switched access lines installed within two days, four days, six days, and more than six days of request. Similar issues may arise with respect to other reporting categories as well. Parties are also requested to address the method of measurement for each service quality element which they believe should be monitored, including sampling techniques which might be necessary or desirable to avoid undue cost or difficulty. Carriers addressing the issue of burdens associated with reporting requirements should provide specific, verifiable, quantitative information about such burdens.

602. Our monitoring proposal is limited to monitoring the quality of the interstate access services provided by the LECs to interexchange carriers. The quality of a long distance telephone call, as perceived by the consumer, is also affected by the quality of the local exchanges in which the call originates and terminates. Excessive dial tone delay, for example, hampers the placement of long distance calls, while noise, blocking, and misdials can occur at either end of a call as well as in the interexchange carrier's network. We tentatively conclude, however, that state commissions extensively monitor, and in some cases actively regulate, the quality of local exchange service, and that this Commission should not duplicate or interfere with their efforts. We propose to share service quality information and concerns with the states, and to seek data about the quality of local service for inclusion in the record of our proposed comprehensive performance review at the end of the initial price cap period. We seek comments on methods of enhancing our cooperation with state regulators in this area.

603. We propose that LEC service quality reports will be submitted quarterly, in a uniform format. We seek comment on whether it would be feasible to include the proposed service quality report in the quarterly ARMIS report which is currently required of each Tier 1 LEC. We also seek comment on whether some form of attestation or independent verification is necessary to assure the accuracy and completeness of the reported data.[1280]

604. We tentatively conclude that our proposals for the treatment of new and restructured services will not contribute to service quality

---

1280 Like other reports submitted by carriers to this Commission, service quality reports would be subject to audit by this Commission's staff.

degradation under a price cap system. New services that are initially offered outside the price cap are brought within price cap limitations after a relatively short period of time, making it impractical for a carrier to attempt to force migration to uncapped services by degrading the quality of capped service. For a migration strategy to work over such a short period, it appears to us that the new service would not only have to be of decidedly superior quality, it would have to be less expensive. An offering of a superior service at a lower price is a benefit to users, so long as the carrier is foreclosed from unimpeded price increases once customer migration is accomplished. By moving a new service into price cap limits relatively quickly, we prevent the carrier from benefiting from such a strategy. Furthermore, our price cap system does not contemplate streamlining new services. As we discuss in Section III.C.5.f, infra, new service tariffs must be filed on 45 days' notice, and must be accompanied by a net revenue showing. In addition, new LEC services will in many cases require waiver of our Part 69 rules. Consideration of such waiver requests will provide additional opportunities for detection of migration strategies that are detrimental to service quality.

3. Impact on State Regulation

a. Summary of Further Notice

605. In the Further Notice, we noted that while our price cap proposal would not change jurisidictional allocation rules, a dominant carrier might attempt to circumvent these rules by inaccurately assigning costs to the state or interstate jurisdiction in an attempt to increase total company profits.[1281] We also noted, however, that the incentive to circumvent proper jurisdictional cost allocations already exists under current regulation whenever a carrier operates pursuant to different state and interstate regulatory regimes. We stated that our ability to detect such activity had improved recently as a result of implementing ARMIS, a computerized system of collecting carriers' financial and operating data.[1282] We tentatively concluded, therefore, that price cap regulation should not adversely affect intrastate rates, services, or jurisdictional allocations. We sought comment on any unique incentives to allocate costs improperly between jurisdictions that might result from price cap regulation, and any specific changes in existing monitoring procedures that might be required to offset such incentives.[1283]

b. Pleadings

606. States, consumer groups, and interexchange carriers argue that price cap regulation provides LECs with an incentive to shift costs to the state jurisdiction as long as their intrastate activities remain regulated under rate of return. These parties argue that by shifting interstate costs to the state jurisdiction, LECs will be able to increase state rates, thereby earning higher profits on interstate services as well as generating additional revenue in the intrastate jurisdiction.[1284] Colorado OCC contends that LECs have a strong incentive under price cap regulation to shift costs because price caps would apply to the smaller part of their business, permitting

---

1281 3 FCC Rcd at 3263-64 (para. 130).

1282 Id. at 3264 (para. 131)(citing ARMIS Order).

1283 Id. at 3264-65 (para. 132).

1284 ALC Comments at 21; Cable & Wireless Comments at 12-13; Comptel Comments at 38-39; NTN Comments at i; TCA Comments at 6; Colorado OCC Comments at 10-11; Maryland PC Comments at 4; Arkansas Comments at 3-4; DC PSC Comments at 12; Florida PSC Comments at 6; Michigan PSC Comments at 9; Missouri PSC Comments at 4; Nevada PUC Comments at 1-2; Ohio PUC Comments at 7; Virginia Comments at 6; Wisconsin PSC Comments at 3; NARUC Reply at 6; Florida's Citizens Reply at 2.

increases on the state side due to misallocation to be "hidden."[1285] Parties argue that the separations rules will not prevent carriers from acting on the incentive to shift costs.[1286] In addition, parties contend, this Commission should not rely on ARMIS, which is untried,[1287] and only applies to Tier 1 carriers.[1288] Nevada PUC argues that, in any case, monitoring only identifies, and does not prevent, jurisdictional cost shifting.[1289]

607. State commissions offer a variety of suggestions for addressing the possibility of jurisdictional misallocation of costs. Michigan PSC proposes that this Commission either require that any percentage change in costs have prior Commission and state approval, or revise the separations rules to make them more specific. Michigan PSC also suggests that this Commission use ARMIS to report to the public, consumer advocates, and state commissions, highlighting major changes.[1290] New York DPS proposes that this Commission increase monitoring and prohibit carriers from increasing the proportion of costs allocated to the state jurisdiction once price cap regulation is in force.[1291] Wisconsin PSC and Ohio PUC state that it is important to keep ARMIS in place.[1292] Ohio PUC also suggests that this Commission monitor jurisdictional allocations, watch for trends, and consider the possibility of carrier manipulation of separations rules in future modifications of these rules.[1293]

1285 Colorado OCC at 17. See also Florida PSC at 6 (75 percent of total LEC costs are assigned to the intrastate jurisdiction).

1286 ALC Comments at 21; Cable & Wireless Comments at 13-14; Arkansas PSC Comments at 3-4; Nevada PUC Comments at 2; Texas PUC Reply at 5; Maryland PC Reply at 13; Florida's Citizens Reply at 2-3 (recent changes in separations rules give carriers additional flexibility).

1287 Colorado OCC Comments at 17-18; Michigan PSC Comments at 9; NARUC Comments at App. C.

1288 Michigan PSC Comments at 9.

1289 Nevada PUC Comments at 2.

1290 Michigan PSC Comments at 10.

1291 New York DPS Comments at 22.

1292 Wisconsin PSC Comments at 3; Ohio PUC Comments at 7-8.

1293 Ohio PUC Reply at 4.

608. Carriers respond that price cap regulation does not result in unique incentives to misallocate costs between jurisdictions, and that existing safeguards are adequate to forestall any cost shifting. Carriers and Ohio PUC argue that there have always been differences between state and federal regulation, including differences in the authorized rates of return.[1294] USTA argues that price cap regulation does not result in any additional incentive to shift costs.[1295] Carriers also argue that states are experimenting with alternatives to rate of return regulation for local exchange carriers.[1296] Finally, NYNEX suggests that any misallocation of costs would be ineffective in the long run as this Commission would make a correction at the time of the performance review, and that knowledge of this limits carrier incentives to shift costs.[1297]

609. Carriers also contend that there are a variety of safeguards already in place that will be effective in forestalling jurisdictional misallocations. Carriers and Illinois argue that existing Commission rules, including the USOA, Part 64 Joint Cost rules, and the Separations Manual, prevent misallocation of costs.[1298] In addition, carriers and the Ohio PUC contend that this Commission can rely on ARMIS to detect cost shifting.[1299] Carriers also expect that state commissions will be effective in preventing carriers from raising their rates as a result of misallocated costs.[1300] Finally, NYNEX and USTA state that the Federal-State Joint Board is developing a program for monitoring jurisdictional cost allocations.[1301]

1294 Ohio PUC Comments at 7-8; Bell Atlantic Comments at 6-7; Pactel Comments at 13; BellSouth Reply at 17; Rochester Reply at 7; USTA Reply at 11.

1295 USTA Comments at 7.

1296 Bell Atlantic Comments at 7; Pactel Comments at 13; Rochester Reply at 8-9.

1297 NYNEX Comments at 60.

1298 Bell Atlantic Comments at 7; BellSouth Comments at 7; Pactel Comments at 13; USTA Comments at 7; NYNEX Reply at 59; Rochester Reply at 8; Illinois Comments at 23.

1299 BellSouth Comments at 7; NYNEX Comments at 38 n.44; Pactel Comments at 13; GTOC Comments at 12; United Comments at 24 n.30; USTA Comments at 7-8; Ohio PUC Comments at 7-8; Rochester Reply at 7-8.

1300 Pactel Comments at 13; GTOC Comments at 12; USTA Comments at 7-8; NYNEX Reply at 60; Rochester Reply at 8 (New York moratorium on rate increases would preclude Rochester from raising rates by misallocating costs).

1301 NYNEX Reply at 60; USTA Comments at 13.

c. Discussion

610. The possibility of cost shifting exists today and is inherent in a bifurcated regulatory system. Federal regulation and state regulation of local exchange carriers have never been identical; the incentive to circumvent jurisdictional cost allocations exists whenever a carrier operates pursuant to different state and federal regimes. Indeed, cost shifting incentives exist even if both the intrastate and interstate jurisdictions employ rate of return regulation if the federal and state earnings targets differ. Therefore, this Commission, along with the state commissions, has developed rules and monitoring programs to identify and prevent cost shifting. We tentatively conclude that the combination of the separations rules, ARMIS, and state monitoring will be effective in identifying and correcting the misallocation of costs to either the state or the interstate jurisdiction.

611. We have in place a system of automated reporting requirements for LECs with annual revenues greater than $100 million.[1302] This automated reporting system, ARMIS, requires carriers to report data by state and interstate jurisdiction, and will enable this Commission to track cost allocations over time. In addition, because ARMIS is already in place for the LECs, ARMIS data for the two years immediately preceding price caps for the LECs will be available, and interested parties, including this Commission, will be able to compare pre- and post-price cap data. Many of the allocation factors tracked by ARMIS are demand-driven; the allocation results we monitor will permit us to detect abnormal trends in cost allocation results. State regulators and this Commission will then be able to judge whether further investigation or auditing is required. LECs will be required to file annual and quarterly reports, which will be available to all interested parties, subject to our rules on requested confidential treatment of proprietary filings.[1303] We expect that states will continue to scrutinize LEC state costs, and disallow those they regard as unjustified. The ARMIS data we collect should be of substantial benefit to state commissions in this process.[1304]

1302 See ARMIS Order, 2 FCC Rcd 6283 (1987); ARMIS Reconsideration Order, 3 FCC Rcd 6375 (1988).

1303 See id.

1304 This Commission has thus far required only carriers with annual revenues exceeding $100 million to file ARMIS reports. Those currently filing ARMIS reports include all Tier 1 carriers, for whom price cap regulation will be mandatory. For all carriers that elect price cap regulation, this Commission will need certain cost allocation data for purposes of monitoring and forestalling cost shifting, as well as data on revenues, expenses, investment,

612. In addition, this Commission, together with various Federal-State Joint Boards, has repeatedly modified and updated the separations rules in an effort to maintain a rational system of allocating costs between federal and state jurisdictions. We have not proposed and do not propose to change any of these rules in this proceeding. Since both the FCC and the state commissions review separations results, shifting costs in a manner that runs counter to our requirements invites regulatory intervention. While there may be disputes concerning interpretations of the separations rules, we tentatively conclude that the existence of these rules operates as a constraint on carrier practices. Given our monitoring capabilities, we tentatively decide that an attempt to narrow the range of disagreement about the application of separations rules would not be a necessary or desirable precursor to the implementation of price cap regulation for the LECs.[1305]

613. We also note that a number of states are exploring alternatives to rate of return regulation. To the extent that a carrier is subject to incentive regulation in both the state and the interstate jurisdiction, any incentive to shift costs between jurisdictions would be minimized. As we have discussed elsewhere in some detail, New York has introduced a profit-sharing plan and rate moratorium. In addition, states such as Ohio, Vermont, Idaho, Maryland, New Jersey, Virginia, and West Virginia have introduced some flexibility or streamlining in their rate of return regulation of LECs. Other states are currently studying reform, and they include Illinois, Michigan, Iowa, Indiana, the District of Columbia, Massachusetts, Florida, California, Nevada, Oregon, and Washington. Thus, even if the adoption of a price cap system for the LECs raised jurisdictional cost shifting concerns, the trend in regulatory reform at the state level is diminishing those incentives.

---

and taxes for purposes of the performance review. One consolidated way of collecting these data would be to develop ARMIS reports for carriers with less than $100 million in annual revenues that elect price cap regulation. We seek comment on this proposal.

1305 The Joint Board monitoring program discussed by NYNEX and USTA is a limited review of the jurisdictional shifts resulting from the conformance of the separations rules to the new accounting rules and from the recent simplification of the separations rules. See Establishment of a Program to Monitor Joint Board Decisions, CC Docket No. 87-339, 2 FCC Rcd 5266 (1987), recon., FCC 88-244, released July 19, 1988. The program is not designed to monitor changes in jurisdictional allocations on an ongoing, long term basis.

4. Eligibility for the LEC Price Cap Plan

a. Summary of Further Notice

614. In considering a LEC price cap plan in the Further Notice, we recognized that this Commission must first resolve complex implementation issues raised by pooling, and by the great diversity among LECs in terms of size, service areas, plant, and customers.[1306] These issues were directly related to the price cap eligibility criteria for LECs that we tentatively settled upon in the Further Notice.

615. We proposed to address LEC diversity generally by permitting carriers to elect participation in our price cap plan.[1307] Although we sought comment on an alternative proposal to make price caps mandatory for Tier 1 LECs,[1308] we tentatively concluded that a voluntary plan would "provide a means of avoiding any unforeseen difficulties relating to carrier diversity...."[1309] In connection with the election, we proposed that in order for a LEC to participate in price caps, it must do so in all of its study areas, and that all of its affiliated carriers must also qualify for the price cap plan and elect to participate.[1310] We tentatively concluded that this

---

1306 Further Notice, 3 FCC Rcd at 3281-82 (para. 165).

1307 Id. at 3283 (para. 170).

1308 Id. at 3286 (para. 177). Tier 1 carriers are currently defined as those companies having more than $100 million in total company regulated revenues, as determined by the 1984 Annual Statistical Volume II of the USTA Statistical Reports Class A and B Telephone Companies for the Year 1983. See Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 43, 67, and 69 of the FCC's Rules), 2 FCC Rcd 5770, 5844 n.4 (1987). Beginning in 1990, however, the definition of Tier 1 carriers will change to coincide with the definition of Class A companies contained in Section 32.11 of this Commission's Rules, 47 C.F.R. §§ 32.11(a), (e). See Commission Requirements for Cost Support Material To Be Filed with 1989 Annual Access Tariffs, Order, DA 88-1554, released Oct. 3, 1988, at 6-7. Under Section 32.11, each company's benchmark of $100 million in regulated revenues is reevaluated annually based upon the company's performance over the previous five years, rather than being fixed based upon its 1983 performance. 47 C.F.R. § 32.11(e).

1309 Id. at 3286 (para. 176).

1310 Id. at 3283 n.307.

"all-or-nothing" rule was a prudent measure to limit incentives to shift costs among study areas or among affiliates.[1311]

616. Although we proposed to make price caps elective, we also determined that both theoretical and practical obstacles existed to applying price cap regulation in a pooled environment. As an initial matter, we concluded that price cap regulation should not disturb important Commission policies, such as the promotion of universal service, which are advanced through the pooling mechanism.[1312] At the same time, we noted that pooling, which involves the sharing of risks, presumably would dampen the efficiency incentives that lie at the heart of price cap regulation.[1313] We tentatively concluded that since price caps would require fundamental alterations to the purposes, structure, and operation of both the traffic sensitive and common line pools administered by NECA, we would limit the availability of price cap regulation to carriers that exited those pools.[1314]

b. Pleadings

617. Most exchange carriers and several states support the proposal in the Further Notice for a voluntary LEC price cap plan, at least during the proposed initial four-year period.[1315] Several of these commenters argue that an optional plan is required because price cap regulation increases carriers' business risks, and, as a new regulatory approach, carries with it a degree of uncertainty.[1316] They note that an elective price cap program will address the potential problems associated with applying a single plan to a diverse

---

1311 Id.

1312 Id. at 3288 (para. 179).

1313 Id.

1314 Id.

1315 See, e.g., Ameritech Reply at 64-65; Bell Atlantic Comments at 7; BellSouth Comments at 10; CBT Reply at 3; GTOC Comments at 2-3; NYNEX Comments at 44 n.51; Lincoln Comments at 1; Pactel Comments at 16; Puerto Rico Reply at 2; SNET Comments at 5; SWB Comments at 5; CCIA Comments at 7; Ohio PUC Comments at 9; Illinois Comments at 15. Smaller LECs generally insist that the election remain a permanent feature of price caps. See, e.g., Independents Reply at 5; NRTA Comments at 1; OPASTCO Reply at 2.

1316 See, e.g., CBT Comments at 7-8; Puerto Rico Reply at 6; Lincoln Comments at 1; CCIA Comments at 7; Ohio PUC Reply at 7.

group of carriers,[1317] and will lessen the administrative burdens of price caps, such as those associated with processing waiver requests.[1318] Several parties also assert that a voluntary approach will create two test groups -- those that elect price caps, and those that remain under rate of return regulation -- which will assist this Commission in evaluating the relative performance of carriers under the respective regimes.[1319]

618. Most other parties commenting on the issue oppose our proposal to make price caps elective.[1320] Some commenters state generally that it is the role of this Commission to select the proper regulatory regime for carriers, and that we should not delegate that role to the carriers themselves.[1321] Several parties also contend that an elective price cap program will increase the administrative burdens on this Commission by forcing us to adopt a dual regulatory system.[1322] However, by far the greatest complaint of opponents of an elective system is that it will result in a process of "adverse selection": i.e., only those carriers that expect to outperform the plan's productivity target will participate, thus leaving consumers as a whole worse off.[1323] These commenters assert that this Commission would be virtually

---

1317 Pactel Comments at 16; Lincoln Comments at 1; GTOC Comments at 2-3; SNET Comments at 5 n.15; CCIA Comments at 7.

1318 See SNET Reply at 2; see also Bell Atlantic Comments at 7; GTOC Comments at 2-3; CCIA Comments at 7.

1319 Ameritech Reply at 66-67; GTOC Comments at 2-3; Ohio PUC Comments at 9. But see Illinois Comments at 16 (asserting that comparing the performance of price cap carriers with rate of return carriers will be of limited utility in evaluating the merits of the two regulatory approaches, because the more productive carriers will tend to select price caps, while the less productive ones will likely remain under rate of return regulation).

1320 See, e.g., AT&T Comments at 70-72; Ad Hoc Comments at 13; Comptel Comments at 7; Executive Agencies Comments at 17; ICA Comments at 23; ICC Comments at 2; IDCMA Comments at 53; TCA Reply at 2-3; Arkansas PSC Comments at 3; Florida's Citizens Comments at 3-4; DC PSC Comments at 19-20; Michigan PSC Comments at 19; Missouri PSC Comments at 6-7; NARUC Reply at 7; NY DPS Comments at 5-6; Oregon PUC Reply at 2; Texas PUC Reply at 7; Virginia Comments at 5; Wisconsin PSC Comments at 7.

1321 See, e.g., Texas PUC Reply at 7. See also IDCMA Comments at 53-54 (asserting that if this Commission believes price caps are preferable to rate of return regulation, we should make price caps mandatory).

1322 See, e.g., Comptel Comments at 7; Illinois Comments at 16.

1323 AT&T Reply at 88-90; Ad Hoc Comments at 12; Comptel Comments at 7; ICA

powerless to curb this abuse of voluntary price caps, since the carriers hold more accurate information regarding their own potential performance than we do.[1324] As a result, most of these parties contend that if we adopt price caps for exchange carriers, we should make the plan mandatory for Tier 1 LECs.[1325] They argue that since Tier 1 carriers account for the vast majority of interstate access revenues, making the plan mandatory for such carriers would lessen the effects of adverse selection, while recognizing the concern that some smaller carriers might be unable to meet the productivity target established under price cap regulation.[1326]

619. Commenting LECs dispute the charge that an elective approach will lead to adverse selection. Ameritech argues that the decision to choose price caps is multidimensional, and will not be based simply on the likelihood of short term profits.[1327] SWB adds that adverse selection should not be a problem since the long term productivity for all BOCs will tend to be the same, while differences in short term performance are impossible to predict accurately.[1328] Most LECs addressing the issue also oppose the alternative proposal to make price caps mandatory for Tier 1 carriers, and elective for smaller carriers,[1329] arguing that Tier 1 carriers are themselves a diverse

---

Comments, Att. B at 69-72; IDCMA Comments at 54; TCA Reply at 2-3; Arkansas PSC Comments at 3; Florida's Citizens Reply at 3-4; DC PSC Comments at 19-20; Michigan PSC Comments at 19; Missouri PSC Comments at 6-7; NARUC Reply at 7; New York DPS Comments at 5-6; Texas PUC Reply at 7; Virginia Comments at 5; Wisconsin PSC Comments at 7.

1324 See generally id.

1325 See, e.g., AT&T Comments at 70-72; Ad Hoc Comments at 13; ICC Comments at 2; NTIA Comments at 5-6; TCA Reply at 2-3.

1326 See, e.g., AT&T Comments at 71-72; Ad Hoc Comments at 13.

1327 E.g., Ameritech Reply at 65-66. See also SNET Reply at 5-6 (contending that adverse selection is not a risk).

1328 SWB Reply at 31-33.

1329 CBT Reply at 3-6; Lincoln Comments at 2; Puerto Rico Comments at 6; Rochester Comments at 9; SNET Reply at 4; United Reply at 3. Cf. Contel Comments at 31-33 (opposing mandatory price caps for Tier 1 carriers unless the all-or-nothing rule is revoked).

group.[1330] However, some LECs would support mandatory price caps for Tier 1 carriers under certain circumstances.[1331]

620. On the issue of pooling, most parties support our tentative conclusion that price caps should not be applied to carriers participating in the NECA pools.[1332] These commenters argue that it would be difficult, if not impossible, to establish a workable price cap plan to govern pools without endangering important public policies, such as those reflected in the Universal Service Fund and Lifeline assistance program.[1333] Some LEC representatives urge this Commission to permit NECA to elect price caps, but they present no specific blueprint for incorporating the pools into price cap regulation.[1334]

621. Numerous small LECs and their representatives indirectly challenge the proposal in the Further Notice to exclude pooling carriers by contending that average schedule companies, which under current rules are required to be pool participants, should be permitted to elect price caps.[1335] Some of these parties do not clearly indicate whether they view the conversion to price caps from average schedules as a start-up problem --requiring use of a one-time surrogate for individualized cost based rates, followed by use of actual data in subsequent years -- or as a means of applying price caps to

---

1330 See, e.g., CBT Reply at 3-6; Lincoln Comments at 2; SNET Comments at 6.

1331 Contel Comments at 31-33 (would agree to mandatory price caps for Tier 1 carriers if all-or-nothing rule were revoked); Pactel Comments at 17-18 (would not object to mandatory Tier 1 plan if individual carriers could seek waivers); US West Reply at 13 (mandatory Tier 1 plan might be satisfactory if the standard applied to above-cap filings were reduced to "substantial cause"); NTCA Reply at 10 (would not object to addressing adverse selection issue through mandatory Tier 1 program). Cf. SWB Reply at 33 (would not object to conditioning the price cap plan on having all BOCs elect to participate).

1332 See, e.g., Illinois Comments at 17; Puerto Rico Reply at 7-8.

1333 See Illinois Comments at 17; Puerto Rico Reply at 7-8.

1334 See, e.g., USTA Comments at 10 n.11.

1335 USTA Comments at 19-20; Alltel Comments at 7; OPASTCO Comments at 12; Century Comments at 9-10. Section 69.605(c)(2) of this Commission's Rules, 47 C.F.R. § 69.605(c)(2), provides that "[a]ny company that does not join in [NECA] ... tariffs for all access elements shall not be deemed to be an average schedule company."

average schedules without ever converting to actual cost. USTA, however, clearly proposes that we adopt the latter approach, stating that average schedule companies could set initial price cap rates based upon the previous 12-month NECA settlement schedule, and could subsequently adjust their caps by replacing the exogenous cost adjustments proposed in the Further Notice with a factor derived from changes computed by NECA in the average schedule formula.[1336]

622. Finally, our proposal to apply price caps to groups of affiliated LECs on an all-or-nothing basis drew considerable comment, mostly from LECs opposing the idea,[1337] but also from several state regulatory commissions that support the proposal.[1338] Supporters of the all-or-nothing rule agree with our tentative conclusion that such an approach will assist this Commission in preventing cost shifting among affiliates or study areas.[1339] Opponents, on the other hand, contend that affiliation is an overbroad and arbitrary criterion by which to combat cost shifting, citing the District of Columbia Circuit's recent decision in Alltel v. FCC.[1340] They argue that the effect of the proposed all-or-nothing rule will be to penalize diversity among affiliates,[1341] discourage participation by LECs in the price cap plan,[1342] and prevent affiliated carriers from selecting the form of interstate regulation that is most consistent with the mode of regulation in effect at the intrastate level.[1343] Some of these parties propose not only that

---

1336 USTA Comments at 19.

1337 See USTA Comments at 16; Alltel Comments at 3; Rochester Comments at 3; Contel Reply at 16; TUECA Reply at 3; TDS Comments at 19-20; Independents Reply at 13-15; NRTA Comments at 3; Century Comments at 7-8; Centel Comments at 6.

1338 Michigan PSC Comments at 19; Ohio PUC Reply at 7. Cf. AT&T Comments at 65 n.**** (asserting that cross subsidy may be a problem between affiliates, and stating that, in particular, this Commission should consider conditioning eligibility for LEC price caps on continued non-affiliation with interexchange carriers).

1339 See Michigan PSC Comments at 19; Ohio PUC Reply at 7.

1340 838 F.2d 551 (D.C. Cir. 1988). See, e.g., USTA Comments at 16; Alltel Comments at 4; Contel Comments at 32-33; TDS Reply at 7; Century Comments at 7-8.

1341 E.g., Century Comments at 7-8.

1342 E.g., Independents Reply at 13-15.

1343 E.g., Alltel Comments at 6. Several parties also raise the issue of

the Further Notice against extending price cap regulation to NECA pool members remains valid and compels the exclusion of these carriers from our price cap plan. Thus, we tentatively conclude that carriers remaining in the NECA pool should not be permitted to participate in the price cap plan proposed in this Second Further Notice.[1346] We discuss timing issues related to depooling and the implementation of price cap regulation for LECs in Section IV.B.5, infra.

625. Although we proposed to take account of LEC diversity in the Further Notice by designing a voluntary price cap plan, upon further review we tentatively conclude that the benefits of price caps can best be achieved by making the scheme compulsory for those LECs serving most ratepayers, i.e., the Tier 1 LECs. We reach this tentative conclusion largely because we are persuaded that the possibility of adverse selection under a fully voluntary plan poses a real, if unquantifiable, risk. As noted above, we do not wish to disturb the delicate balancing reflected in the pooling policies this Commission has adopted in other proceedings. Thus, we do not propose to require any carriers to withdraw from the CCL pool due to our price cap rules. However, we tentatively conclude that Tier 1 carriers that do choose to withdraw from the CCL pool must be made subject to price caps in order to

---

the lines of those adopted for traffic sensitive rates in Regulation of Small Telephone Companies, CC Docket No. 86-467, Report and Order, 2 FCC Rcd 3811 (1987), were extended to carrier common line rates, more small carriers might depool and become eligible for price caps. See OPASTCO Comments at 6-10. The relationship between simplified rate of return procedures and the feasibility of price caps for small carriers is not readily apparent to us on this record. We would welcome clarifying comments. However, to the extent that commenters are requesting that we make reforms to current rate of return procedures for carriers that do not elect price caps, we believe such issues should be debated in the context of rate of return proceedings.

1346 Since under current rules average schedule companies must be carrier common line pool members (see 47 C.F.R. § 69.605(c)(2)), our proposal to exclude pooling carriers from price caps also has the effect of precluding price caps for average schedule companies.

affiliates be permitted to elect price caps independently, but that individual companies be permitted to choose price caps on a study area basis.[1344]

c. Discussion

623. We have carefully considered the comments on LEC eligibility, including, on the one hand, concerns regarding LEC diversity and the continued promotion of universal service, and, on the other hand, concerns about potential ratepayer harm from adverse selection under a voluntary program. Based upon our review of the record, we reaffirm our conclusion in the Further Notice that price cap regulation ought not to apply to carriers -- including average schedule carriers -- participating in the NECA pools. We believe, however, that some modification of the price cap eligibility criteria presented in the Further Notice is warranted. Our proposed modifications take the form of two general rules and one limitation on those rules. First, we propose that price caps be mandatory for all Tier 1 carriers that withdraw from NECA's carrier common line (CCL) pool, and for all affiliates of such carriers. Second, we propose that other non-pooling LECs may elect price caps, on an all-or-nothing basis, if none of their affiliated carriers remains in either the common line or traffic sensitive (TS) pools. Finally, in defining the scope of both mandatory and elective price caps, we propose to exempt average schedule companies from the all-or-nothing rule so that such carriers may continue to be reimbursed for their costs on the basis of average schedules after their affiliates convert to price cap regulation.

624. Reconciliation of pooling and price cap regulation is a basic issue that gives shape to our tentative decisions on LEC eligibility. We have repeatedly emphasized in this proceeding how price cap regulation will increase carriers' incentives to achieve heightened efficiency, which in turn should lead to lower service rates. Pooling, by its nature, entails risk-sharing and a concomitant diminution of incentives to operate efficiently. Thus, to harmonize price cap regulation and pooling would require fundamental changes in our pooling rules. The record in this proceeding, however, sheds little, if any, light on how to overcome these obstacles and fashion a workable price cap plan for the pools. While a few parties make vague statements in support of price cap participation by pooling carriers, most commenters support our tentative view that pooling LECs should be excluded from price cap regulation.[1345] We believe that the reasoning presented in

---

how this Commission would, consistent with the all-or-nothing rule, handle the acquisition of a rate of return carrier by a holding company whose operating companies are all subject to price caps. See Alltel Comments at 6; USTA Comments at 17 n.28.

1344 See, e.g., Contel Reply at 16; TUECA Reply at 3.

1345 OPASTCO seems to suggest that if simplified tariff procedures along

capture the benefits we seek to achieve through price cap regulation.[1347] For other non-pooling LECs, we believe that permitting voluntary participation adequately balances the interests of ratepayers with the need to recognize carrier diversity.

626. The Tier 1 operating companies currently account for approximately 95 percent of interstate access revenues.[1348] At the same time, Tier 1 carriers comprise only a small minority of the total of over 1400 LECs throughout the country, the rest of which generate the relatively small remaining portion of interstate access revenues. Thus, we believe that establishing the dividing line between mandatory and voluntary price caps on the basis of this classification reasonably addresses the competing concerns that, in the aggregate, exchange carriers could "game" a voluntary system to the detriment of ratepayers, and that a single compulsory price cap system would unfairly burden some, particularly smaller, carriers.

627. We recognize that Tier 1 carriers may themselves comprise a diverse group, though we believe the remaining, smaller carriers to be, on average, more susceptible to dramatic shifts in revenues and costs. However, as we discuss in greater detail in the Section on LEC productivity, we tentatively conclude that the possibility of harm to carriers or ratepayers arising from our making price caps mandatory would be adequately addressed by the inclusion of an additional backstop in the LEC price cap proposal to ensure the continuance of just and reasonable rates. An automatic stabilizer adjustment in the price cap index formula would be one form of adjustment. As we discuss in greater detail subsequently, such an adjustment should operate to bring prices within the zone of reasonableness and to keep them there even if a

---

1347 All Tier 1 carriers, except Lincoln Telephone and Telegraph Company and Puerto Rico Telephone Company, have filed their own depooled CCL rates for the tariff year beginning April 1, 1989. See Letter from Vice President --Tariff, Cost and Regulatory Matters, NECA, to Chief, Common Carrier Bureau, FCC, dated Sept. 6, 1988. Thus, our proposal would make price caps mandatory for all Tier 1 LECs, except Lincoln and Puerto Rico. We do not believe that a plan to make price caps mandatory for depooled Tier 1 carriers would have affected the initial decisions of such carriers regarding withdrawal from the CCL pool. Nevertheless, we seek comment on whether depooled Tier 1 carriers should be given an opportunity to reconsider their pooling decisions in light of our price cap proposal.

1348 Such companies provided 94.3 percent of all carrier common line minutes of use during the period from October 1987 through September 1988. Letter from Director - Tariff and Regulatory Matters, NECA, to Secretary, FCC, Dec. 15, 1988.

carrier's actual productivity performance deviates substantially from the productivity performance assumed in setting the productivity factor of the price cap index. Alternatively, we could conduct an earlier comprehensive review. We seek comment regarding our tentative conclusion that a plan which combines mandatory and voluntary price caps in the manner described herein will best balance competing concerns regarding adverse selection and LEC diversity.

628. We also conclude that, except for average schedule companies, price caps should apply on an all-or-nothing basis in order to limit the risk of cost shifting. The dampening of incentives to shift costs has been one of our principal objectives throughout this proceeding, and is, in fact, a major reason why we believe the price cap model is a better form of regulation than rate of return. As we discussed in Section II.B, supra, price cap regulation substantially curtails the economic incentive to shift costs to capped services, since the cap on prices limits a carriers' ability to raise rates to accommodate the shifted costs. However, these same disincentives do not exist to curtail the shifting of costs from price cap carriers to affiliated cost carriers subject to rate of return regulation, since the latter carriers can thereby raise their rates.[1349]

629. Our concerns about the impact of cost shifting from price cap carriers to cost carriers subject to rate of return do not extend to average schedule companies affiliated with price cap carriers. Average schedule carriers are reimbursed for their access costs on the basis of formulas derived from statistical studies of comparable companies. As a consequence, an average schedule company's rates would not be affected by an attempt to shift costs from a price cap affiliate to the average schedule company. Thus, we propose to permit those companies currently operating under average schedules to continue to do so after their affiliates become subject to price cap regulation.[1350] We seek comment on this proposal.

1349 This concern regarding the shifting of costs between affiliates differs from that presented by inconsistent interstate/intrastate regulation. We already have jurisdictional separations rules (Part 36) and ARMIS to protect against the latter concern, and we wish to avoid the necessity of establishing detailed new inter-affiliate cost allocation rules in this proceeding. Moreover, unlike the cost shifting incentives inherent in our statutorily mandated dual interstate/intrastate regulatory system, the incentive to shift interstate costs among affiliates is within our authority to address in a structural manner.

1350 Since (1) we propose to exclude pooling carriers from price caps, (2) average schedule companies must be CCL pool members under current rules, and (3) current CCL depooling rules mandate depooling on an all-or-nothing basis, our proposal to allow average schedule affiliates of price cap carriers to retain average schedule status will require modification of the current

630. As a result of the all-or-nothing rule we are proposing, price caps would be mandatory for cost affiliates of depooled Tier 1 carriers, as well as for the Tier 1 carriers themselves [1351] With respect to those carriers for whom price cap regulation is voluntary, eligibility would be contingent upon depooling and participation in price caps by all affiliated cost LECs. We recognize that application of the all-or-nothing rule may have the effect of limiting somewhat LECs' choices with respect to price cap regulation. As evidenced by our proposed treatment of average schedule companies, we have attempted to preserve LECs' options to the extent they are consistent with the positive incentives we seek to create. We tentatively conclude, however, that on balance the need to limit opportunities for cost shifting outweighs the incidental restrictions on additional choices resulting from application of the all-or-nothing rule. [1352]

631. We reject the assertion made by several exchange carriers that the D.C. Circuit's Alltel decision somehow precludes us from imposing price caps on an all-or-nothing basis. The Alltel court did not issue a blanket attack

---

depooling requirements, the current rules requiring average schedule companies to be pool members, or both. We seek comment on the implications of this tentative conclusion in terms of its potential impact on pooling policy, and otherwise.

1351 Pursuant to the procedures set out in our common line depooling Orders, carriers electing to withdraw from the NECA CCL pool must do so on an all-or-nothing basis. MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, Report and Order, 2 FCC Rcd 2953, 2956-57 (paras. 25, 27)(1987); Memorandum Opinion and Order on Recon., 3 FCC Rcd 4543, 4550-52 (1988). Thus, our proposal to make price caps mandatory on an all-or-nothing basis for Tier 1 and related cost carriers that withdraw from the CCL pool does not itself compel CCL depooling by any carriers. That decision has already been made at the holding company level independent of price caps.

1352 A number of commenters raise questions regarding how to apply the all-or-nothing rule in connection with mergers and acquisitions involving price cap carriers and carriers subject to rate of return regulation. See, e.g., USTA Comments at 17 n.28; Alltel Comments at 6. We are sympathetic to concerns that a strict application of the all-or-nothing rule may have the effect of altering, or at least complicating, transactions in which price cap and rate of return carriers are merged or otherwise consolidated. We wish to resolve this issue in a manner consonant with our concerns regarding LEC diversity and potential cost shifting. However, the current record on this subject is not well developed. We therefore seek further comment on this issue.

on regulatory distinctions premised upon corporate affiliation. Rather, the court struck down as arbitrary and capricious a rule that "require[d] an average schedule company affiliated with a cost company to convert to cost status ... if the aggregate revenues of that company and its affiliates equal or exceed $40 million."[1353] In doing so, the D.C. Circuit concluded that, on the record in that case, average schedule eligibility criteria based upon the size of a group of affiliated carriers were irrelevant to the stated purposes behind those criteria, i.e., to avoid imposing unnecessarily burdensome costs on small carriers. The court stressed:

> The economy of scale [in the preparation of cost studies] appears to arise as a function of the size of the exchange carrier rather than as a function of the size of the affiliated group of carriers. That is a crucial point in this case.[1354]

632. As discussed above, unlike the rule at issue in Alltel, we propose to use the all-or-nothing criteria to limit the ability of carriers to shift costs among affiliates, not as a means of distinguishing those carriers that can avail themselves of scale economies from those that cannot. Moreover, in contrast to the all-or-nothing rule in Alltel, which required certain carriers to relinquish existing rights -- i.e., average schedule status -- we propose to employ the affiliation criteria in a manner that merely circumscribes additional choices, i.e., eligibility for price caps. Finally, unlike Alltel, the all-or-nothing rule we are proposing herein does not affect average schedule companies at all. We tentatively conclude that our proposed use of the all-or-nothing rule here advances our goal of preventing cost shifting in a balanced and reasonable manner.

5. Timing of Implementation

a. Summary of Further Notice

633. In the Further Notice, we proposed that AT&T and the LECs be permitted to elect price cap regulation by filing inaugural tariffs to be effective April 1, 1989.[1355] We tentatively concluded that delaying price caps for the LECs would unnecessarily defer the full attainment of anticipated consumer benefits.[1356] At the same time, however, we found no evidence that

---

1353 838 F.2d at 555.

1354 Id. at 557 (emphasis added).

1355 Further Notice, 3 FCC Rcd at 3368 (para. 304).

1356 Id. at 3282 (para. 166).

simultaneous implementation was required to prevent harm to the public interest; and we requested those parties claiming that ills -- such as bypass -- could result from staggered implementation to comment further regarding their concerns.[1357]

634. We selected the April 1, 1989, date for implementing price caps in part because it coincided with the timetable we had established in other proceedings[1358] for CCL depooling and for the completion of scheduled increases in subscriber line charges,[1359] and in part because it was "the earliest practicable time that price cap tariffs could be filed subsequent to the release of a final order in this proceeding."[1360] We anticipated that, pursuant to the CCL depooling procedures we had established, most large LECs would be filing carrier common line rates based upon their own costs as of April 1, 1989. Nevertheless, we proposed to hold the LECs' carrier common line element out of price cap regulation for one year to ensure that the initial depooled rates for that element had been tested prior to incorporation into the price cap scheme [1361]

1357 Id. at 3282-83 (para. 169).

1358 See MTS and WATS Market Structure, Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board, CC Docket Nos. 78-72 and 80-286, Report and Order, 2 FCC Rcd 2953 (1987).

1359 See Further Notice, 3 FCC Rcd at 3368, 3427 (paras. 305, 428).

1360 Id. at 3368 (para. 305).

1361 Id. at 3292, 3317 (paras. 185, 223).

b. Pleadings

635. Most LECs, and a number of other commenters, support the proposal in the Further Notice to initiate price caps for the LECs and AT&T on April 1, 1989.[1362] These parties contend that applying price caps to the LECs is necessary to ensure that consumers benefit, since access charges comprise approximately one-half of AT&T's regulated interstate costs.[1363] In addition, a number of commenters contend that if price cap regulation is applied to AT&T alone, the LECs will face an increasing risk of bypass as AT&T seeks to cut costs and the LECs, under rate of return, are denied the flexibility to meet competition from alternative access providers.[1364]

636. While supporting generally our proposed starting date for price caps, many LECs take issue with our tentative decision to exclude the carrier common line element from the plan during the first year.[1365] They contend that by maintaining rate of return regulation for a substantial portion of their access services, the plan will weaken efficiency incentives that would otherwise occur under price caps.[1366] In addition, they assert that the estimate of productivity growth reflected in the proposed price cap index formula will be overstated if the common line element is excluded.[1367] They state that the CCL element can easily be included in price caps from the outset by using data from the NECA settlements as points of reference to evaluate initial depooled CCL rates under price caps.[1368] On a related issue, a number of LECs contend that we should give carriers that do not withdraw

---

1362 See, e.g., BellSouth Comments at 20-21; CBT Comments at 8; GTOC Comments at 3; NYNEX Comments at 3; Pactel Comments at 15; SNET Comments at 12; CCIA Comments at 6; Illinois Comments at 23.

1363 E.g., CCIA Comments at 6; GTOC Comments at 3; Pactel Comments at 15.

1364 E.g., CBT Comments at 8; Pactel Comments at 15; CCIA Comments at 7; Illinois Comments at 23. Puerto Rico proposes that if this Commission decides upon staggered implementation, we should start with the LECs first. Puerto Rico Comments at 2.

1365 See, e.g., Ameritech Comments at 5-6; CBT Comments at 8-9; SNET Comments at 15-16.

1366 E.g., Ameritech Comments at 6; CBT Comments at 9.

1367 E.g., Ameritech Comments at 6; SWB Comments at 28.

1368 See, e.g., Ameritech Comments at 6.

from the common line pool until 1990 a second opportunity to elect price caps.[1369]

637. In addition to those parties opposing price cap regulation for the LECs at any time,[1370] many commenters argue that this Commission should implement the new regulatory regime first for AT&T, and then, at a subsequent time, for exchange carriers.[1371] Others contend that April 1989 is simply too soon to implement price caps for any carriers.[1372] Proponents of staggered implementation contend that excluding exchange carriers from price cap regulation at the outset will allow this Commission additional time to resolve LEC-specific implementation issues, and will give us the benefit of the experience gained from applying price caps to AT&T.[1373] Several of these parties directly dispute LEC claims that such a course would increase AT&T's incentives to bypass LEC facilities.[1374]

c. Discussion

638. In this Report and Order and Second Further Notice, we have determined that a workable price cap plan for AT&T is ready for adoption. We have also adopted the conclusion that the price cap model is superior to

---

1369 See, e.g., Contel Reply at 17; Illinois Telco Comments at 1-2; NYNEX Comments at 43; Rochester Comments at 3; TUECA Reply at 4; USTA Reply at 18. Cf. Century Comments at 6 (proposing that carriers be permitted to elect to enter price caps in each of the first four years).

1370 E.g., Cable & Wireless Comments at 1-4; Comptel Comments at 4-5; DC PSC Comments at 19; Maryland PC Comments at 2-4.

1371 E.g., Ad Hoc Comments at 6-8; ALC Comments at 8; Colorado OCC Comments at 31; Executive Agencies Comments at 4; ICA Comments at 22; Ohio PUC Comments at 1-2; New York DPS Comments at 6-7.

1372 Arkansas PSC Comments at 3-4; Michigan PSC Comments at 22; NTN Comments at 2-3.

1373 E.g., Ad Hoc Comments at 7-8; ALC Comments at 8; Colorado OCC Comments at 31; New York DPS Comments at 7.

1374 See, e.g., New York DPS Comments at 8-9 (arguing that bypass incentives are unlikely to differ under price caps, and in any event, that bypass is a long term phenomenon that would not develop substantially within the initial four-year price cap period); AT&T Reply at 26-28 (arguing that competition, not price caps, creates bypass incentives, and that regardless of the manner in which AT&T is regulated, LECs must remain efficient to prevent bypass); MCI Comments at 9 n.9 (disputing bypass risk).

rate of return regulation for local exchange carriers.[1375] At the same time, however, we recognize that our earlier proposal with respect to implementation for the LECs requires modifications on which further public comment is warranted. Thus, we have decided to go forward with implementation of price caps for AT&T as of July 1, 1989, as we continue consideration of issues related to the LECs. That decision finds ample support in our discussion of the AT&T plan, and renders moot, for the purposes of this Second Further Notice, the issue of whether we should implement price caps simultaneously for AT&T and the LECs.[1376]

639. This Commission has attempted in this Second Further Notice to resolve the remaining implementation issues related to the LECs. Since we have concluded that a properly designed price cap plan for local exchange carriers will generate significant public interest benefits, we propose to implement our modified plan as expeditiously as possible. We believe that implementation of price caps is most efficiently and meaningfully achieved in the context of annual revisions to access tariffs. Thus, we propose that price caps would be implemented with the filing of annual access tariffs to be effective July 1, 1990. We would require that depooled Tier 1 carriers and their cost affiliates file their initial price cap tariffs at that time. We propose that other eligible LECs may elect price cap regulation by filing annual price cap access tariffs to be effective July 1, 1990.[1377] As in the Further Notice, we propose that LECs file their annual price cap tariffs on at least 90 days' notice.

640. The decision to proceed with another comment cycle regarding LEC price caps, thus delaying implementation for a short period, will have the effect of removing several features of the implementation timetable in the Further Notice that have drawn criticism. First, our earlier proposal to

---

1375 See Section II, supra.

1376 We observe in passing that those parties who raise the specter of bypass in connection with staggered implementation have done so only in the most general terms, giving this Commission no reason to depart from our view, expressed in the Further Notice, that there is no evidence "that simultaneous implementation of price caps for AT&T and the LECs is required in order to prevent harm to the public." Further Notice, 3 FCC Rcd at 3282 (para. 169)(emphasis in original). To the contrary, we believe in this instance that the public is best served by implementing expeditiously those reforms that are ready, while perfecting those that are not.

1377 As discussed in Section IV.B.4.c, supra, cost carriers unaffiliated with Tier 1 LECs are eligible for price cap regulation if: (1) they and their cost affiliates are not members of either the traffic sensitive or CCL pool; and (2) they and their cost affiliates all elect price caps.

hold the carrier common line element out of price caps during the first year due to a lack of tested data on carrier-specific CCL rates will no longer apply. Most large carriers and their affiliates have filed their own CCL rates for the tariff year beginning April 1, 1989.[1378] Thus, we will have a full year's experience with such rates prior to the initial price cap filings, and the price and demand data generated by these depooled carrier common line charges can be readily applied to our proposed price cap formulas. For those remaining potential price cap carriers that withdraw from the CCL pool effective July 1, 1990, we believe that our experience in evaluating the carrier-specific CCL rates filed in connection with the 1989 annual access tariff filings will permit us to construct needed base period price and demand data for the initial price cap filing using data from NECA settlements.[1379] Thus, we tentatively propose to bring the CCL element under price caps from the outset for all carriers subject to price cap regulation.

641. In addition, our proposal to commence price caps for LECs effective July 1, 1990, responds to the requests of several LECs that we provide a second price cap election date to allow carriers that had not already elected to withdraw from the CCL pool as of April 1, 1989, to participate in price caps beginning in 1990. Under our modified proposal, carriers that are still members of one or more of the NECA pools during the tariff year beginning April 1, 1989, will have time to withdraw from such pools in order to establish their eligibility for price caps.[1380] We tentatively decline, however, to provide additional price cap elections during the initial four-year period under the new regulatory regime.[1381] Permitting numerous elections would likely complicate the administrative burdens connected with the transition from rate of return to price caps. Moreover, late entry into price cap regulation might provide insufficient time, prior to comprehensive review, to generate fully the efficiency enhancing incentives we seek to create.

1378 Of the Tier 1 carriers, only Lincoln Telephone and Telegraph Company and Puerto Rico Telephone Company will remain in the CCL pool as of April 1, 1989. See Letter from Vice President -- Tariff, Cost and Regulatory Matters, NECA, to Chief, Common Carrier Bureau, FCC, dated Sept. 6, 1988.

1379 We also propose to use NECA settlement data to assess the initial price cap rates filed by carriers that leave the TS pool effective July 1, 1990.

1380 Carriers must notify NECA of their intention to withdraw from the TS and CCL pools by December 31, 1989, in order to exit such pools effective July 1, 1990. See 47 C.F.R. § 69.3(e); see also Access Tariff Filing Schedules, CC Docket No. 88-326, Report and Order, 3 FCC Rcd 5495 (1988).

1381 See, e.g., Century Comments at 6 (proposing that carriers be allowed to elect price caps in each of the first four years).

C. The Mechanics of the Proposed LEC Price Cap Plan

1. The Price Cap Index (PCI)

642. As discussed previously,[1382] the price cap index is the formula used to measure the extent to which a carrier must adjust its rates in order to qualify for streamlined review of its tariff filings. The formula incorporates (1) the effects of changes in the cost of production factors, (2) differences between industry productivity growth and that of the economy as a whole, (3) and other specific cost changes, called exogenous cost changes, which affect the carrier's cost of operation but over which the carrier itself exercises minimal or no control. Our intent in fashioning and applying such a formula is to ensure that aggregate rates under a price cap regime move in response to changes in carriers' costs, thereby keeping rates in the zone of reasonableness.

643. In the Further Notice, we proposed to use this basic, three-part formula in connection with price cap regulation of both AT&T and the LECs. Our review of the record accumulated in response to the Further Notice presents no basis for altering our conclusion that the basic formula is an appropriate foundation for adjusting both AT&T and LEC price caps in order to ensure cost-based rates. Therefore, we reaffirm that tentative conclusion.

644. In addition to resolving issues concerning the basic structure of the formula, we must renew our evaluation of the formula components to determine if modifications are required in implementing price cap regulation for LECs.[1383] In the Further Notice, we proposed to use the same values and means for both AT&T and the LECs: (1) GNP-PI as a measurement of inflation; (2) a productivity factor of 3 percent (2.5 percent representing productivity gains over and above those experienced economy-wide, plus 0.5 percent for the Consumer Productivity Dividend); and, (3) a series of specific exogenous cost adjustments. Earlier in this Order, we conducted such an evaluation with regard to issues and arguments exclusively or logically relating to AT&T. We now turn to an analysis of issues that pertain to the LECs.

1382 See Section III.C.1., supra.

1383 Elsewhere in this Order we propose an adjustment to the formula for use in connection with the LECs. This adjustment is offered as a means of accounting for certain unique technical properties of the common line interstate access service provided by the LECs. See Section IV.C.1.c., infra. We tentatively conclude that this proposed adjustment does not alter fundamentally the nature of the basic, three-part formula discussed in the text, above.

a. Exogenous Costs

645. In the Further Notice we identified certain costs triggered by administrative, legislative or judicial action beyond the control of the carriers, costs that we tentatively concluded should result in an adjustment to the cap. Those costs included access charge changes; changes in tax laws; changes in the rate of flow-back of excess deferred taxes; changes in expense levels caused by the expiration of the current depreciation amortization program; changes caused by amendments to Part 36 of our Rules (the Separations Manual), and changes to the Uniform System of Accounts. Commenting parties sought to add to this list. We now discuss how we would propose to treat each of these costs seriatim.

646. Access charges. In Section III we have determined that changes in access charges should be treated as exogenous costs by AT&T. We now tentatively conclude that, to the extent that a LEC pays or imputes to itself an amount equal to tariffed access charges for originating or terminating its interstate basic service offerings, changes in the levels of such charges justify an adjustment to the price cap index for the basket containing interstate corridor services.[1384] We have required the LECs providing such services to charge themselves the same tariffed access rates that they charge independent interexchange carriers. Those rates are subject to Commission review. To maintain competitive parity among dominant carriers providing interstate switched or private line services, we tentatively conclude that the access charges these carriers incur should be treated like those incurred by AT&T.

647. Tax law changes. In the Further Notice we proposed to treat changes in tax liability due to changes in the tax laws as exogenous costs. The amount of this adjustment was to be calculated based on historical, rather than projected, costs. We further proposed that any change in the rate at which a carrier is flowing back excess deferred taxes resulting from the Tax Reform Act of 1986 must be reflected in an exogenous cost adjustment.

648. Carriers uniformly favor treating tax law changes as exogenous in calculating the price cap index.[1385] A number of other parties oppose exogenous treatment of tax law changes on the grounds that such changes are reflected in the GNP-PI and would be double-counted if given exogenous treatment.[1386] Carriers dispute the allegation of double-counting. NYNEX

1384 The proposed grouping of LEC services into individually-capped "baskets" is discussed in Section IV.C.2.b., infra.

1385 See, e.g., BellSouth Comments at 23; NYNEX Comments at 28; SNET Comments at 10; SWB Comments at 31.

1386 See Ad Hoc Comments at 28; API Comments at 24; DC PSC Comments at 13;

contends that the GNP-PI does not reflect tax law changes currently,[1387] while Pactel believes that the GNP-PI reflects the impact of tax law changes on a carrier's input costs but not the impact of tax law changes on its own tax liability.[1388] BellSouth states that utilities are subject to unique assessments because they serve as tax collectors for all levels of government, and that they should be allowed cost adjustments for changes in this type of tax.[1389] Carriers also seek clarification of the treatment of various tax law changes involving investment tax credits and accelerated depreciation.[1390] These pleadings are summarized in greater detail in Section III, supra.

649. In Section III we determined that, at least for AT&T, tax law changes should be presumed to be reflected already in the GNP-PI adjustment factor. We tentatively conclude that a similar conclusion is warranted for LEC operations. We note, however, that our decision to treat costs associated with tax law changes as endogenous was influenced in part by the size and breadth of AT&T's operations. We seek comment on whether the more regionalized, if not localized, nature of LEC operations should cause us to reach a different conclusion concerning the ability of the GNP-PI to mirror the effects of tax changes on those carriers' costs, and if so, why.

650. Separations Manual changes. In the Further Notice we proposed to require adjustments to the PCI for changes in interstate costs due to changes in the Separations Manual. Nearly all parties addressing this issue support our proposal, although New York DPS asks that we require federal and state regulatory approval for changes which increase the allocation of costs to the intrastate jurisdiction. In Section III we concluded that changes in cost allocations arising from Commission-prescribed changes in the separations process are exogenous cost changes that should be reflected in AT&T's price cap formula, but that no prior regulatory approval should be required before such an adjustment is made. We tentatively reach that same conclusion for the LECs.

651. Depreciation Rates and Amortization Amounts. In the Further Notice we tentatively concluded that changes in depreciation rates shculd not be

---

TCA Reply at 19 n.39.

1387 NYNEX Reply at 23.

1388 Pactel Reply at 72-73; see also USTA Reply at 42-43.

1389 BellSouth Reply at 56-57.

1390 BellSouth Comments at 61; NYNEX Comments at 29; Ameritech Comments at 34 n.16.

treated as exogenous cost changes because the prime determinant of those rates is the carrier's own decisions on deployment and retirement of assets, and not this Commission's decisions in prescribing rates. We did, however, propose to require downward adjustments to the PCI upon the expiration of a carrier's current amortization of its depreciation reserve deficiencies.

652. LECs strongly contest our conclusion that depreciation rates are controlled by the carrier and not by this Commission [1391] SNET, for example, cites its own experience of being denied as high a depreciation rate as it wished to use as proof that this Commission is the prime determinant of depreciation rates.[1392] Ameritech and NYNEX argue that, if there is to be an exogenous cost decrease at the end of the amortizations, then consistency requires that we allow an increase whenever depreciation rates go up.[1393] A number of LECs urge that we grant carriers greater freedom in setting depreciation rates if we are not going to treat depreciation rate changes as exogenous.[1394] These pleadings are summarized in greater detail in Section III, supra.

653. In Section III, we conclude that an adjustment to reflect the reduction in expenses associated with Commission prescribed depreciation amortization schedules should be included in the AT&T price cap formula, but no similar adjustment should be made to reflect routine depreciation expense. As we note in that discussion, the request for and arguments to support similar treatment of depreciation amortization expenses and routine depreciation expense came from LEC commenters. Examination of our earlier discussion clearly shows that the reasoning that led us to reject their proposal with respect to AT&T would apply to the treatment of depreciation expense in a LEC price cap plan. As with AT&T, we conclude that carrier control over investment decisions would render exogenous treatment of depreciation rate changes inconsistent with price cap incentives. Thus, we tentatively conclude that there should be an adjustment to LEC price caps to reflect the expiration of the depreciation amortization schedules, but no similar adjustment to reflect ordinary depreciation expense. We further tentatively conclude that this is not the proper forum in which to consider changes to the manner in which we prescribe depreciation rates.

1391 See, e.g., Ameritech Comments at 33; CBT Comments at 21; GTOC Comments at 44; NYNEX Comments at 27-28.

1392 SNET Comments at 28-30.

1393 Ameritech Comments at 35; NYNEX Comments at 28.

1394 See BellSouth Comments at 60 n.57; GTOC Comments at 44; Pactel Comments at 60 n. 88; SWB Comments at 32.

654. USOA Changes. All those commenting on the treatment of costs attributable to changes in our Uniform System of Accounts agree that these costs should be considered exogenous. We have adopted this proposal for AT&T and we again tentatively adopt it for the LECs. In their pleadings, several LECs argue that costs arising from changes in generally accepted accounting principles, or GAAP, should also be considered exogenous. In Section III we agree with their conclusion that it is difficult to distinguish changes triggered by an amendment to our USOA from those triggered by a change in GAAP. Nonetheless, because changes in GAAP cause changes in the regulatory accounting procedures of carriers under our jurisdiction only after we find such changes compatible with regulatory accounting needs, we conclude in Section III that AT&T should adjust its price cap to reflect changes in GAAP only after we have approved such a change. We now propose the same treatment of GAAP changes for the LECs.

655. Equal Access Costs. In the Further Notice we tentatively concluded that the costs of converting to equal access should not be treated as exogenous. We stated that such treatment was not warranted because decisions concerning equal access implementation were intricately related to the future structure of the network and, hence, to productivity.

656. Some LECs argue that they should be allowed to make an adjustment to the price cap for equal access conversion costs. They note that endogenous treatment would have a disproportionate impact on smaller LECs; since the BOCs and GTOC are already well into the process, their conversion costs are already reflected in the rates that will form the starting point for price cap regulation.[1395]

657. We remain concerned that, if equal access costs were considered exogenous, carriers would have no incentive to convert to equal access in the most productive manner possible. They might also have incentives to shift other switched access costs into the equal access category. Nonetheless, the comments have caused us to reconsider our tentative conclusion that no price cap LEC should be allowed exogenous treatment of any portion of its equal access conversion costs. We tentatively conclude that LECs which have not begun equal access conversion at the time they become subject to price cap regulation may request permission to treat equal access conversion costs as exogenous when they do begin the conversion process. We further tentatively conclude that "equal access conversion costs" shall, for this purpose, be defined as they are currently defined for purposes of Parts 36 and 69 of this Commission's Rules.[1396] We seek comment on these tentative conclusions.[1397]

1395 See, e.g., Contel Comments at 21-22; USTA Comments at 47-48; Rochester Reply at 20.

1396 See 47 CFR § 36.191 (equal access investment) and 47 CFR § 36.421(equal access expense). The Part 36 definitions are referenced in Part 69.

658. AT&T Point of Presence Migration. Some LECs urge us to include an exogenous factor to reflect AT&T's replacement of the leased facilities through which it meets some of its access needs with facilities and services taken under interstate access tariffs.[1398] They argue in effect that this shift leaves stranded investment that they will be unable to recover under a price cap plan unless there is such an exogenous factor. We seek further information on the nature, extent, origin, and scope of this problem. We particularly urge LECs advocating exogenous treatment of these costs to provide a clear, numerical demonstration of the effects of point-of-presence migration, including any impacts on the allocation of costs between the intrastate and interstate jurisdictions.

659. Contributions to the LTS and TRS Funds. Some telephone companies propose that we treat changes in pooling support obligations as exogenous costs.[1399] These obligations, in the form of annual contributions to the Long Term Support Fund and the Transitional Support Fund created by our Pooling Order[1400], are an essential component of the plan crafted by the Joint

---

1397 In seeking comment of this issue, we are particularly interested in how smaller LECs that have not yet begun equal access conversion would be affected by exogenous treatment of equal access costs under the current configuration of Part 69. This Commission recently decided to institutionalize our practice of permitting LECs to employ an optional equal access element in their access charges. Amendment of Part 69 of the Commission's Rules for the Recovery of Equal Access Costs, CC Docket 78-72, FCC 89-16, released February 17, 1989. If equal access costs incurred by smaller LECs are treated as exogenous under price cap regulation, and these same LECs elect to employ an equal access rate element, interexchange carriers seeking to challenge equal access rates will likely cite equal access cost data filed as part of the PCI calculations. Under the proposal set forth in this Order, this type of challenge would only be possible against those companies that have not yet begun conversion to equal access and that have decided to employ an optional equal access element. Given that use of the equal access element is optional, it does not appear that any additional Commission action is necessary to protect small companies that have not yet begun the conversion process from rate challenges that are not possible against larger companies that have installed equal access. We seek comment on this tentative conclusion.

1398 See, e.g., Century Comments at 15; CBT Comments at 22; United Comments at 19-20; USTA Comments at 48-49.

1399 See, e.g., USTA Comments at 49-50; Rochester Comments at 20; SWB Comments at 31-33; Pactel Comments at 38-40.

1400 Pooling Order, 2 FCC Rcd 2953 (1987), recon., 3 FCC Rcd 4543 (1988).

Board to permit depooling of the carrier common line access element without endangering the financial viability of small, high-cost telephone companies. The companies reason that because this Commission has prescribed the obligation to contribute and the formula for determining the level of contribution to be made by a LEC withdrawing from the CCL pool, these contributions are properly classified as exogenous costs. We tentatively agree. We solicit comments on this tentative conclusion that Long Term Support Fund and Transitional Support Fund contributions should be treated as exogenous costs, changes in which should be reflected in our price cap formula.

660. Costs reallocated under Section 64.901. Pactel argues that adjustment required under Section 94.901 of our Rules due to failure of a carrier accurately to forecast relative regulated and nonregulated plant usage should be treated as an exogenous cost adjustment. In Section III we found that exogenous cost treatment of investment reallocated from regulated to nonregulated use was indeed necessary in order to give effect to the joint cost rules in a price cap environment. We tentatively reach the same conclusion with respect to the LECs. We seek comment on this conclusion.

661. Other Exogenous Costs. In Section III we consider comments proposing that we add an exogenous cost factor for: (1) all cost changes mandated by this Commission; (2) tax consequences of all regulatory decisions; and (3) uncontrollable "extraordinary" costs. We have declined to add such exogenous cost factors to the price cap plan we have adopted for AT&T. We tentatively conclude that such factors should also not be included in our LEC price cap proposal. There may be some regulatory decisions the consequences of which would warrant an adjustment to the LEC price cap formula. We believe that this determination is one that should be made on a case-by-case basis, however, and that is how we would propose to proceed. We tentatively reach a similar conclusion with respect to the treatment of the tax consequences of future regulatory decisions. Finally, we tentatively conclude that treating all extraordinary costs as exogenous would reduce carriers' incentives to be efficient and innovative. We note that we have sought to avoid introducing such counterincentives in the LEC price cap plan we presented in the Further Notice and the one we now present. We have consciously introduced mechanisms that may dampen carriers' incentives to be efficient or innovative only when we have concluded that there were countervailing public policies or interests, like universal service or protecting ratepayers from unreasonably high or discriminatory rates. We detect no such countervailing policies that would weigh in favor of treating all extraordinary costs as exogenous.

b. GNP-PI

662. For AT&T, we have adopted the Gross National Product Price Index, or GNP-PI, as the measure of inflation that most closely mirrors changes in

the cost of factors of production.[1401] The reasoning that led us to adopt this index for AT&T applies with equal validity to its use in a LEC price cap formula. Those expressing opposition to use of the GNP-PI did not identify any characteristic of the LECs that would make this index a less suitable measure of the cost of factors of production for their services than it is for AT&T's services. For this reason, we tentatively conclude that the first component of the formula defining a LEC price cap index should also be based on measurements of the GNP-PI. We propose that the annual measure of change in the GNP-PI should be calculated by comparing the GNP-PI for the quarter ending six months before the effective date of the price cap tariff to the corresponding quarter of the previous year.

663. The GNP-PI is published at the close of each quarter and subsequently is subject to correction at standard intervals. We are requiring AT&T to use the estimate of the GNP-PI made 75 days after the close of the quarter relevant to its annual price cap tariff filing. Some LECs have asserted that release of the so-called 75-day estimate of the most recent quarter's GNP-PI would occur less than two weeks before their tariff filings were due, leaving them little time to incorporate these data into their calculations and to prepare timely tariff filings.[1402] They propose that the earlier 45-day estimate of GNP-PI be used instead. In its comments, GTOC submitted a table showing that there has historically been little change between the 45-day estimate and the 75-day estimate.[1403] After reviewing these data we tentatively conclude that LECs should be permitted to use the 45-day estimate of the GNP-PI for the quarter occurring six months before the effective date of price cap tariffs.

c. LEC Productivity

i. Summary of the Further Notice

664. The productivity adjustment in the price cap formula is designed to ensure that changes in prices for telecommunications services closely match anticipated changes in the costs of providing those services. Increases in productivity permit a firm to produce more output with the same inputs or the same output with fewer inputs. Since productivity growth permits the same output to be produced with less inputs, it reduces the cost of producing that output for given factor prices.

1401 See Section III.C.1.a, supra.

1402 See, e.g., Centel Comments at 9; GTOC Comments at 37-39; Pactel Comments at 19; USTA Comments at 39; NYNEX Comments at 34; Rochester Reply at 16-17; US West Comments at 46.

1403 GTOC Comments at App. 5.

665. The Further Notice noted that the GNP-PI price index already reflects economy-wide productivity increases because it tends to rise at the rate of factor price increases minus the rate of productivity growth for the economy as a whole. If the productivity growth of the telecommunications industry were the same as for the overall economy, then no additional productivity adjustment would be needed to the price cap index. But productivity growth in the telecommunications industry historically has exceeded the economy-wide average.

666. In the Further Notice we examined several studies of the long term productivity growth of the Bell System. We concluded that "the telecommunications industry, and the Bell System in particular, have been a distinctly productive sector of the U.S. economy. Relative to overall productivity and prices, the industry has shown a long term differential of about 2 percentage points per annum since the 1930's, with a somewhat larger differential of about 2.5 percentage points per annum in more recent years."[1404] We went on to argue that "2.5 percent per year is a reasonable estimate of potential future productivity gains if existing regulatory methods remain in place. We tentatively found that none of the available studies or other evidence provides any basis for assigning a different productivity adjustment for the LECs relative to AT&T."[1405] In the Further Notice we also proposed that an additional .5 percent "Consumer Productivity Dividend" be added to the historical productivity differential to ensure that consumers share in the anticipated efficiency gains from implementing price caps.[1406]

667. We requested comment on our tentative selection of a 3 percent productivity factor and on the evidentiary foundation for our conclusion. We also requested commenters to submit additional data relating to productivity. We noted that the available data did not differentiate the productivity achievements of long distance carriers from those of local exchange carriers, nor were data available which would permit us to calculate the difference, if any, in potential productivity gains of small and large LECs. We suggested that the mechanics of our proposal might be in need of adjustment if long term productivity gains vary widely among carriers relative to total industry productivity measured on the same basis.[1407] We expressed special interest in

---

1404 Further Notice, 3 FCC Rcd at 3405 (para. 378).

1405 Id. at 3407 (para. 385).

1406 Id. at 3407-08 (para. 386).

1407 See id. at 3285 n.310.

obtaining data relating to small company productivity as a possible basis for setting a separate productivity factor for small carriers.[1408]

668. The assignment of a specific LEC productivity number generated the largest and most contentious comments concerning our tentative conclusions about the mechanics of the PCI.

ii. Pleadings

669. The record submitted on LEC productivity can be divided into the following categories: (1) studies that attempt to quantify LEC productivity and responses to those studies; (2) general comments about how current industry trends might affect productivity; (3) comments about how inclusion of carrier common line charges in a price cap system ought to affect the selection of a productivity number; and (4) whether there is support for assigning a different productivity number to small telephone companies. In discussing each of these categories, commenters generally found that the 2.5 percent productivity number we proposed was either too low,[1409] too high,[1410] or that there was insufficient evidence available for a productivity factor to be determined.[1411] Pactel states that the productivity factor proposed in the Further Notice would be "challenging" but acceptable.[1412] Most of the other large LECs state that a 2 percent productivity adjustment should be used.[1413] We will summarize the comments in each of

---

1408 Id. at 3412 (para. 396).

1409 Connecticut OCC Comments at 10; Comptel Comments at 12; DC PSC Comments at 14; EDS Comments at 3, 12; Florida PSC Comments at 4; MCI Comments at 41; NTN Comments at 33; New York DPS Comments at 11-12; Ohio PUC Comments at 15; TCA Comments at 17-18. These commenters believe that the productivity factor ought to be 4.5 percent to 9.9 percent. Compare Maryland PC Comments at 15-16 with Ad Hoc Comments at 35-36 and AT&T Comments, App. E.

1410 E.g., CCIA Comments at 12; CBT Comments at 6; Centel Comments at 12; NYNEX Comments at 22; United Reply at 2-3.

1411 NTIA Comments at 9; Maryland PC Comments at 12-14; Missouri PSC Comments at 9; Arkansas PSC Comments at 3; DC PSC Comments at 15-16; Federal Executive Agencies Comments at 8; IDCMA Comments at 13-14; Indiana UCC Comments at 14-15; MCI Comments at 13-14.

1412 Pactel Reply at 57.

1413 E.g., Bell Atlantic Comments at 16-17; BellSouth Comments at 25; SNET Comments at 17; United Comments at 7.

these areas in turn, beginning with comments on the various studies submitted by the parties or relied on by this Commission in our Further Notice.

670. Bell Communications Research (Bellcore) submitted its first LEC productivity study on March 17, 1988, prior to the adoption of the Further Notice. That study compares the average price of interstate access in May 1984 and December 1986, after adjusting for certain exogenous changes. It found that prices rose at an annual rate of 1.54 percent less than the annual rate of change in CPI for the period. According to the study, if a price cap plan similar to what the LECs were proposing had been in effect during the study period, and if the productivity adjustment factor had been set at 1.54 percent, the average price of interstate access would have been the same at the end of 1986 as under rate of return regulation.

671. The price cap plan simulated in the Bellcore study differs in three important ways from the plan we subsequently proposed in the Further Notice. First, Bellcore assumes there would be a single basket for all interstate access services, while this Commission proposed two baskets. Second, the Bellcore study does not adjust rates for demand stimulation due to regulatory changes, while this Commission proposed that such stimulation be treated as an exogenous adjustment factor for the CCL charge.[1415] Third, the Further Notice proposed to measure inflation by the GNP-PI fixed weight price deflator, not the CPI-U used in the Bellcore study. In an effort to increase the usefulness of the data underlying the Bellcore study in determining accurately LEC productivity during the post-divestiture period, we requested that the Bellcore study be revised to conform to the plan proposed in the Further Notice.[1416]

672. Prior to the time an updated Bellcore study was filed that conformed to the regulatory plan contained in the Further Notice, several parties submitted studies which implicitly estimate the productivity differential for the LECs in the post-divestiture period. AT&T presents one such study in which it calculated the productivity adjustment factor it

---

1415 3 FCC Rcd at 3293 (para. 187). Even if the price cap plan adopted were not to make an adjustment for demand stimulation from exogenous factors, such an adjustment should still be made in calculating the historical productivity factor. The numerous exogenous changes, including the introduction of SLCs, during the period immediately following divestiture stimulated demand to an extent unlikely to be repeated in the future. Thus taking out the effect of such exogenous stimulation is likely to give a better projection of productivity for a period when relatively less stimulation of this kind is anticipated.

1416 Id. at 3412 (para. 395).

claimed would be necessary under price caps to replicate the price path for switched access under rate of return regulation.[1417] AT&T concludes that productivity would be either 7.1 percent if the price cap formula includes an adjustment for exogenous shifts in demand or 9.9 percent if it does not.

673. In their reply comments, the LECs criticize AT&T's methodology.[1418] The LECs generally point to one or more alleged "flaws" described by Ernst & Whinney in their review of the AT&T study for USTA.[1419] First, the LECs claim that AT&T's use of ratemaking minutes instead of total minutes in its calculations led AT&T to overstate the growth rate in minutes. They note that because of the conversion to equal access, ratemaking minutes, which are the sum of premium minutes plus 55 percent of non-premium minutes, have been growing more rapidly than total minutes during the recent past. When an exchange is converted to equal access there is a jump in ratemaking minutes even if total minutes are unchanged because non-premium minutes become premium minutes. According to these LECs, as equal access conversion is largely completed, this source of increase in ratemaking minutes will henceforth greatly decline. Thus, they argue that the future growth rate in both ratemaking minutes and total minutes is likely to be less than the rate at which ratemaking minutes have grown during the recent period of conversion to equal access.

674. Overstating the growth rate in minutes, the LECs argue, overstates the historical rate of decline in average prices because such prices are calculated as revenues divided by minutes, and the more rapid the historical decline in average prices, the larger the productivity factor needed to make prices under price caps fall at that rate. The LECs also argue that AT&T's choice of time period distorted its estimation of LEC productivity. AT&T used June 1985 to May 1986 as its base period and carried out its analysis through 1988. When BellSouth redid AT&T's analysis starting in May 1984, the resulting productivity factor was 0.6 percent [1420] Ernst & Whinney's correction of the AT&T analysis found a productivity factor of 1.3 percent.[1421] These commenters also note that AT&T's analysis ignored special

---

1417 AT&T Comments, App. E.

1418 Ameritech Reply at 30-33; NYNEX Reply at 37-39; SWB Reply at 28; Pactel Reply at 61-64; USTA Reply at 34-35 & Att. A (Ernst & Whinney review of the AT&T Study).

1419 USTA Reply at Att. A.

1420 BellSouth Reply at Att. C.

1421 USTA Reply, Att. A at 34-35.

access, which, they argue, has had much lower productivity growth than switched services. If the objective is to estimate the average productivity of all access services, they state, leaving out special access overstates the result.

675. In addition to AT&T's efforts to calculate LEC productivity, Ad Hoc and ICA submitted a consultant's report critiquing Bellcore's initial efforts to quantify LEC productivity.[1422] According to the report by ETI, the first Bellcore study contains flaws that serve to depress the productivity calculation. ETI states that the adjustments for exogenous costs contained in the Bellcore report were not converted to a present value basis, and that the productivity factor reported is more a reflection of increased depreciation since divestiture than any real change in LEC productivity.[1423] Furthermore, ETI states that while Bellcore counted the entire carrier common line revenue requirement in developing average 1988 access costs, it failed to include both originating and terminating CCL in its calculations for 1984. Had the calculation been done correctly, ETI asserts the LEC productivity calculation would result in a 9.1 percent productivity factor.[1424] Rather than rely on the Bellcore study, ETI urges that we employ its own "backcast" analysis, originally advanced in the pleadings leading up to the Further Notice, that compares LEC prices to general inflation to determine a suitable productivity level.[1425]

676. The LECs defend the Bellcore study, arguing that since Bellcore's calculations were done on the basis of access minutes, as opposed to calls, the calculations correctly employed the CCL charges only once.[1426]

1422 Ad Hoc Comments, ETI Report.

1423 Id., ETI Report at 33 & App. A at 1-2.

1424 Id., ETI Report at App. B. Accord Maryland PC Comments at 13.

1425 Ad Hoc Comments, ETI Report at App. A at 1-2. ETI argues that the best way to determine LEC productivity is simply to determine what productivity value, if it had been in place over the last ten years, would have been necessary to yield rates that are currently in existance. ETI does not appear to make any adjustments in its calculation for exogenous costs. According to ETI, if this Commission's proposed 3 percent productivity factor had been subtracted from the CPI in each year over the past few years, rates would currently be much higher than they are today. Id. See also CFA Reply at 9 (endorsing the ETI productivity approach); Networks Reply at 12-14 (urging careful consideration of the ETI analysis).

1426 Bell Atlantic Comments at 17, n.34. See also BellSouth Comments at 31. On August 26, 1988, Bellcore submitted an extensive rebuttal to the ETI "backcast" analysis and ETI's critique of the first Bellcore study. Letter

Furthermore, SWB argues that ETI's own analysis of LEC productivity is flawed, since it fails to take into account changes in the subscriber line charge and other exogenous costs.[1427] Pactel argues that the ETI approach does not make the proper comparisons between overall economic productivity growth and industry productivity that are necessary to establish a productivity number that can be used as part of this Commission's formula, i.e., a productivity differential.[1428]

677. On August 18, 1988, Bellcore submitted its second study of LEC productivity during the post-divestiture period. This study concludes that LEC industry productivity was -0.07 percent for switched access, -5.27 percent for special access, and -0.43 percent for total access. In its reply comments, AT&T subjects the second Bellcore study to critical analysis.[1429] AT&T concludes that the Bellcore study contains a number of serious errors and estimates that, when these errors are corrected, the productivity factor becomes 7.23 percent for switched access and 6.63 percent for special access.[1430]

678. AT&T claims that the second Bellcore analysis of switched access contained three significant errors. First, AT&T asserts, the Bellcore study does not correctly adjust for the direct assignment of WATS access lines to special access. According to AT&T, direct assignment of WATS reduces both the

---

from Stanley P. Williams, Bellcore, to Acting Secretary, FCC, August 26, 1988. The letter explains that Bellcore's calculations were made on the basis of an average CCL rate per access minute. Bellcore also states that that ETI's "backcast" analysis is meaningless because it does not conform to the price cap proposal, and while adjusted for some years for access charge changes, does not contain adjustments for other exogenous factors. ETI responded to Bellcore's critique, arguing that it selected the 1976-1983 time period to avoid most of the significant exogenous changes and that the separations rules in effect at that time produced distortions in productivity calculations that require an upward adjustment for productivity. ETI also states that its "undocumented" exogenous adjustment for access was in fact very close to the amount Bellcore used in its study. Ad Hoc Reply, ETI Report at App. B.

1427 SWB Comments at 8, n.18. See also Pactel Reply at 60.

1428 Pactel Reply at 59. See also PRTC Reply at 16-17 (finding that ETI's approach is based on incorrect assumptions, fails to correct for regulatory changes, and misapplies Bellcore methodology).

1429 AT&T Reply, Att. C.

1430 See also Ad Hoc Reply at 14 (stating that the second Bellcore study is "irredeemably flawed").

revenue requirement recovered by the CCL charge and the number of minutes subject to that charge, but Bellcore only adjusts for the reduction in the revenue requirement. AT&T argues that failing to adjust for the reduction in minutes improperly lowered the Bellcore estimate of LEC switched access productivity. AT&T adjusts for the reduction in minutes from direct assignment by excluding "closed-end" WATS minutes from its estimate of the CCL charge in 1984. This adjustment increases the 1984 average LEC price in AT&T's study, resulting in a larger decline in prices in that study for the period from 1984 through 1988 and, thus, a productivity estimate larger than the one calculated by Bellcore.

679. Second, AT&T asserts that Bellcore miscalculates certain exogenous cost changes. According to AT&T, Bellcore "erroneously included the impacts of regulatory changes that were realized in 1984 among its exogenous regulatory changes or Z adjustments." AT&T claims that the simulation of price caps should only include those adjustments that would be made under the plan. AT&T argues that if the plan had been in effect beginning in 1984, there would be no adjustments for exogenous changes prior to 1984 even if their effects first appeared in the the price at the beginning of 1984. Thus, AT&T argues for deletion of Bellcore's adjustments for CPE and inside wire. AT&T also claims that Bellcore's exogenous adjustment for the 1987 reduction in the authorized rate of return should be deleted because, AT&T argues, changes of this nature would be irrelevant in a price cap environment.

680. The third flaw AT&T identifies is Bellcore's use of "an improper and unrepresentative starting point." According to AT&T, "[d]ata prior to June 1985 are incomplete and unreliable because of changes in data collection procedures occasioned by divestiture.... Because the initial 1984 rates were anomalously low in light of subsequent rate revisions, the break-even [productivity factor] calculated on the basis of these rates is substantially lower than if a more realistic and representative base period were used."[1431]

681. Finally, AT&T challenges Bellcore's analysis of special access. It argues that Bellcore made four errors. First, AT&T states that Bellcore's representation of special access price changes in terms of revenue per channel termination was inappropriate. Second, it characterizes "the 'K' factor used in the Bellcore study as arbitrary and yielding Voice Grade and DS-1 revenue requirements inconsistent with LEC filed data." Third, it asserts that return adjustment should also be excluded. Finally, it charges that Bellcore had used inconsistent sources for base and end period revenue requirements and demand data.

1431 AT&T Reply, App. C at 12.

682. Ad Hoc also criticizes the second Bellcore study. Ad Hoc argues that price comparisons like Bellcore's are inherently unreliable because they assume that Bellcore followed the price cap proposal to the letter, that rate of return administration was perfectly efficient, and that the period studied is typical and a useful predictor of the future.[1432] According to Ad Hoc and its consultant, Bellcore misinterpreted the price cap proposal in treating changes in authorized rate of return as exogenous, and in calculating exogenous cost factors.[1433] Ad Hoc also states that our administration of rate of return was not perfect, and that many rates remain under investigation. Furthermore, Ad Hoc argues that Bellcore's use of channel terminations in estimating special access productivity is flawed, and that the period studied is not representative of normal, long term trends.[1434]

683. On September 8, 1988, Bellcore submitted a third study. This study calculates a separate historical productivity factor for each of the seven RBOCs, as well as an aggregate productivity factor for the total LEC industry. The total industry historical productivity factor for total access is calculated to be -0.7 percent. RBOC productivity numbers ranged from -2.6 for BellSouth to 6.59 for US West.[1435] Several BOCs discount the difference in productivity factors generated for the individual regional companies. BellSouth, for example, argues that despite the spread between the lowest and highest productivity numbers, most RBOC productivity numbers cluster around the average.[1436] Pactel argues that if the study period were longer, the individual LEC productivity factors would have been more uniform. According to Pactel, we should not be troubled by the differences in productivity numbers

---

1432 Ad Hoc Reply, ETI Report at 12.

1433 Id. at 12-14.

1434 Id. at 14-20.

1435 In addition to the third Bellcore study, Ameritech also filed separate information concerning a productivity study it conducted based on changes to its operating expenses from 1975-1983 and 1985-1987. Ameritech's methodology was to subtract the percentage change in its operating expenses from the percentage change in the GNP-PI to achieve an estimated productivity number. Ameritech Comments at 20-21 and Att. A. This yielded a productivity factor of .08 percent for 1976-1987, or -1.19 percent for 1976-1982 and 3.03 percent from 1985-1987. Ameritech Reply at 34. AT&T disputes Ameritech's figures, arguing that if done properly, Ameritech's study would reveal a productivity factor of 3 percent since operating expenses increased an average of 3 percent above the GNP-PI. AT&T Reply at 82-83.

1436 BellSouth Reply at 30-31. See also NYNEX Reply at 31-32.

gleaned from such a short term study.[1437] Bell Atlantic states that disaggregation of the second Bellcore study into individual company numbers was extremely complicated due to the need to allocate demand and revenue adjustments to individual companies, and that the process of allocation may have caused the numbers to be different.[1438]

684. In addition to comments about, and responses to, the various studies submitted by Bellcore, AT&T, and ETI, commenters also discuss the studies that were cited in the Further Notice as evidence for a 2.5 percent productivity factor. Some parties argue that our analysis of existing productivity studies in the Further Notice underestimates what the actual productivity gains are.[1439] Others argue that the studies we reviewed to come up with a 2.5 percent productivity offset are out of date and reflect only pre-divestiture experience.[1440] These parties argue that we should rely on more recent data in determining LEC productivity. Bell Atlantic, for example, argues that the second Bellcore study demonstrates that productivity should be less than 2 percent per year.[1441] BellSouth, however, argues that the studies we cite in fact support a 2 percent, but not a 2.5 percent productivity offset.[1442] CBT argues that of those studies available to us,

---

1437 Pactel Reply at 67-68.

1438 Bell Atlantic Comments at 17 n.36.

1439 E.g., Ad Hoc Comments, ETI Report at 32.

1440 Ameritech Comments at 18; Indiana UCC Comments at 16; USTA Comments at 43; GTOC Comments at 31-33; US West Comments at 59-63. NYNEX Comments at 23-24; SWB Comments at 7. As discussed in the AT&T discussion of productivity, SWB continues to advocate use of productivity data generated by the American Productivity and Quality Center (APQC). SWB Comments at 7-9. See also USTA Comments at 41-43; US West Comments at 59-63. But see Ad Hoc Reply, ETI Report at 3-6 (arguing that APQC data contains serious flaws). ETI's position was refuted by the APQC. See Ad Hoc Reply, ETI Report at App. A (letter from N. Preston of APQC to ETI).

1441 Bell Atlantic Comments at 16-17 (arguing that the Bellcore result is confirmed by the productivity information published by the American Productivity and Quality Center).

1442 BellSouth Comments at 25. In an appendix to its comments, BellSouth explains that the predivestiture Christiansen study, which is employed to support our tentative finding of LEC productivity, shows that while a unified Bell System attained a productivity level of 3.2 percent, the independent LECs attained productivity of only 1.9 percent over the period 1947-1979. According to BellSouth, this suggests that divested BOCs would be capable of less productivity gains than would AT&T. BellSouth Comments, App. at 9 (statement

those that explicitly include LECs tend to support a productivity factor of 2 percent.[1443]

685. Some parties argue that our attempt in the Further Notice to corroborate the 2.5 percent figure by evaluating the difference between the overall CPI and the CPI Telephone Index was flawed. Bell Atlantic argues that we looked at the incorrect study period, and that a comparison of the overall and CPI telephone indexes for 1977 through 1987 would have revealed only a 2 percent per year price difference.[1444] BellSouth argues that we should compare the CPI Telephone Index with the GNP-PI instead of the overall CPI. According to BellSouth, that calculation yields an estimated price differential of 1.74 percent.[1445]

686. Parties make a variety of arguments about what is likely to happen to LEC productivity in the near future if price cap regulation is adopted.[1446]

---

of A. Kahn). Furthermore, BellSouth argues that the data contained in the Christiansen study demonstrate that as local service increased in relative importance within the unified Bell System, productivity tended to decrease. Id. at 10-11. GTOC also conducted an analysis of the Christiansen data, similarly concluding that a shift toward more toll activity in the unified Bell System was associated with a higher productivity level. GTOC Comments at App. 3. See also MCI Comments at 6. NYNEX has also manipulated the Christiansen data, substituting Christiansen's measure of economy-wide productivity with the BLS multifactor productivity index, and concluding that telecommunications productivity differential was actually 1.4 percent from 1949 to 1978. NYNEX Comments, App. A at 5-7 (statement of D. Dugan and J. Schlosser). See generally PRTC Comments at 6-8.

1443 CBT Comments at 18-19 (citing the internal Bell System study showing a differential of 1.8 percent, the first Bellcore study showing a differential of 1.54 percent, and the FCC's own study of AT&T productivity showing a differential of 2.48 percent).

1444 Bell Atlantic Comments at 17, n.35. See also United Comments at 6; NYNEX Comments at 25. NYNEX argues that if we had compared the CPI indexes from 1935 through 1985, the annual price differential would have been 1.95 percent. NYNEX Comments, App. A at 9 (statement of D. Dugan and J. Schlosser). But see Indiana UCC Comments at 17-18 (finding that the relatively short time frame of our CPI comparison renders the result relatively useless since it does not match the longer term studies).

1445 BellSouth Comments at 30-31. NYNEX makes the same calculation, but comes up with a differential of 1.6 percent. NYNEX Comments, App. A at 9-10 (statement of D. Dugan and J. Schlosser).

1446 We discussed many of these arguments in the AT&T discussion of

Some argue that LECs are about to experience substantial growth in productivity gains spurred by installation of state of the art technology.[1447] Some state that productivity should be adjusted upward to account for the elimination of the Averch-Johnson effect.[1448] Others state that more accommodation should be made to what they perceive is a rising trend in LEC productivity.[1449]

687. The LECs argue that productivity has fallen off in recent years.[1450] According to BellSouth, the "rising trend" some perceive in industry productivity is actually caused by a decline in economy-wide productivity in the recent period.[1451] LECs also argue that traffic concentration plays a key role in the ability to take advantage of economies of scale, and that, as a result, AT&T is in a better position to generate

---

productivity, supra.

1447 Ad Hoc Comments at 28 n.21 and ETI Report at 17-18 (signalling system 7 and fiber optics will contribute to LEC productivity); API Comments at 8-9; Connecticut OCC Comments at 10; Florida PSC Comments at 5; Hawaii Comments at 6, n. 6; ICA Comments at 18-19; IDCMA Comments at 13-22; Maryland PC Comments at 14-15; MCI Comments at 7-13; AT&T Reply at 83-84. ETI, for example, argues that the telephone network is becoming increasingly computerized and that computer costs are decreasing. Ad Hoc Comments, ETI Report at 19-29. But see USTA Comments at 41-43 (arguing that technological improvements are not likely to generate productivity gains over the next four years); BellSouth Reply at 24-25 (most of the costs of signalling sytem 7 have not yet been incurred); PRTC Reply at 14-16; USTA Reply at 36-40 (arguing that LECS have been upgrading their networks to the new technologies for 15 years and no productivity "windfalls" can be expected). Indiana UCC states that price caps should not prevent ratepayers from benefiting from technological improvements that they have already financed. Indiana UCC Comments at 18.

1448 Ad Hoc Comments at 34. See also AT&T Comments at 68. According to Ad Hoc, this increase should amount to at least 2 to 3 percent over this Commission's current estimate of LEC productivity. Ad Hoc Comments at 34. See also Connecticut OCC Comments at 10-11; ICA Comments at 19-20.

1449 Ad Hoc Comments, ETI Report at 15-16.

1450 E.g., Ameritech Comments at 19.

1451 BellSouth Comments at 26-29. See also NYNEX Comments at App. A at 7-8 (statement of D. Dugan and J. Schlosser). According to NYNEX, other studies corroborate a general downturn in economy-wide productivity. NYNEX Comments, App. A at 8-9 (statement of D. Dugan and J. Schlosser) (acknowledging that most recently, the general economy is becoming more productive).

large productivity gains.[1452] SNET argues that productivity increases are likely to be more closely linked to changes in demand than to changes in factors companies can control.[1453]

688. Ad Hoc argues that it is better to overestimate productivity, since carriers possess more information about their operations than we have.[1454] AT&T states that selection of a productivity factor for LECs is far more difficult and significant a task due to the absence of competition for LEC services.[1455] BellSouth, however, warns that there are limits to a carrier's ability to generate productivity gains.[1456]

689. Parties also discuss the effect that inclusion of the carrier common line charge will have on productivity and how carrier common line should be capped. Some parties advocate that the CCL should be capped on a per line basis, as opposed to a per minute basis.[1457] AT&T states that because CCL charges decline with increases in volume, a per minute cap would ignore the two factors that cause costs to change -- changes in demand and changes in the number of access lines.[1458] According to AT&T, our proposed adjustment for the effects of demand stimulation caused by exogenous factors does not correct the fundamental flaw in a per minute cap approach because the adjustment ignores changes in the number of access lines and excludes a substantial part of demand growth.[1459] AT&T states that if CCL were capped on a per minute basis in the past, the CCL would today be higher than it

---

1452 BellSouth Comments at 32-34 & App. at 6-9 (statement of A. Kahn). See also Ameritech Reply at 26-28; NYNEX Reply at 36-37. But see Ad Hoc Reply, ETI Report at 20-22 & App. D (statements that LECs lack scale economies are "fatuous").

1453 SNET Comments at 14-15.

1454 Ad Hoc Comments at 37-38.

1455 AT&T Comments at 67-68. See also MCI Comments at 3 (arguing for a higher productivity offset for LECs due to absence of competition). But see NYNEX Reply at 34-35 (arguing that LECs are subject to competition in the form of network bypass).

1456 BellSouth Comments, App. at 4-6 (statement of A. Kahn).

1457 Ad Hoc Comments, ETI Report at 37-38.

1458 AT&T Comments at 53-56.

1459 Id. at 56-57.

is.[1460] AT&T argues that a per line cap protects consumers because an increase in demand will not generate a windfall for LECs.[1461] BellSouth argues that our per minute cap should be adopted. According to BellSouth, a per line cap permits revenues to increase as the number of access lines increase, while any increase in demand (or, minutes) that lowers prices benefits interexchange carriers only.[1462] Ameritech argues that the adjustment for demand stimulation from exogenous factors is difficult to administer and fails to include an adjustment for demand repression if exogenous costs cause rates to rise.[1463] NYNEX argues that such an adjustment unfairly double counts productivity generated from increased CCL demand. According to NYNEX, this is already included in the productivity offset.[1464]

690. A number of parties discuss carrier-specific productivity numbers, or the possibility of using a different number for small carriers. Some parties argue that using one productivity factor for all carriers rewards those that have been inefficient, and that company-specific indexes should be employed.[1465] Ad Hoc argues for a prescription-type hearing where each LEC's productivity number would be determined.[1466] Ameritech, however, argues that carrier-specific calculations are inconsistent with price cap regulation, because carriers would have no incentive to beat the productivity mark if they knew it would increase according to their specific performance.[1467] NYNEX argues that individual company productivity numbers would be difficult to calculate.[1468] SWB argues that selection of a productivity number is a

---

1460 Id. at 57-58 & App. E.

1461 Id. at 59, n.***.

1462 BellSouth Comments at 52-56 (also finding that the per line method requires use of forecasted data that are more susceptible to dispute). See also NYNEX Reply at 21-23. But see AT&T Reply at 74-76 (arguing that lower CCL charges result in lower rates to end users and that the forecasting required is not onerous).

1463 Ameritech Comments at 24.

1464 NYNEX Comments at 46-47. See also BellSouth Comments at 57-58; USTA Comments at 27-28.

1465 Ohio PUC Comments at 16; Florida PSC Reply at 2-3, 5-6; NARUC Reply at 5 & App. C.

1466 Ad Hoc Reply at 16-17.

1467 Ameritech Reply at 34.

1468 NYNEX Reply at 30-31.

predictive exercise and is not susceptible to the precision some parties argue should be applied.[1469]

691. Several interested parties filed information in response to our request in the Further Notice for data concerning small LEC productivity. USTA, for example, introduced a study by Ernst & Whinney which argues that small LECs are disadvantaged relative to large LECs in connection with potential productivity gains because the slower demand growth experienced by small LECs presents such companies with fewer opportunities to move down the cost curve and thereby achieve productivity gains.[1470] The third Bellcore study also distinguishes between the productivity gains achieved in the post-divestiture period by the RBOCs and the independent LECs. The latter group lagged behind the RBOCs' achievement by approximately one percent, according to the Bellcore study.[1471] Parties also argue that the Christiansen study and other studies of LEC productivity provide support for the finding of lower productivity gains for smaller companies.[1472]

692. Alltel states that the smaller companies have had large productivity increases historically that will limit their ability to achieve substantial gains in the future.[1473] NRTA argues that small LECs face a

---

1469 SWB Reply at 33-34.

1470 USTA Comments, Att. A, "Implications of Demand Growth and Technological Change for Productivity Gains by Small Telephone Companies." Ernst & Whinney measured the growth in output of small and large companies, concluding that annual growth rates for the 1985 through 1987 period were about 8.9 percent for the smallest companies (less than 2,500 access lines) and about 13.9 percent for carriers with over 200,000 access lines. Ernst & Whinney argue that this growth differential provides indirect evidence of different productivity levels for large and small carriers. See also Alltel Comments at 10 (productivity is likely to increase with the addition of intelligence into the network, a feature that small companies will not have the demand for); OPASTCO Comments at 17-18 (small companies have fewer opportunities to generate efficiencies).

1471 Bellcore, "The Impact of the FCC Proposed Price Cap Plan on Interstate Consumers-Regional Disaggregation," Sept. 8, 1988 at 4 (hereinafter Bellcore Third Study).

1472 NTIA Comments at 8; USTA Comments at 43 (noting that the Christiansen study found that independent LECs had a lower productivity performance than did the unified Bell System). NTIA also cites a study of Michigan Bell, finding a productivity factor of 1.9 percent. NTIA Comments at 8.

1473 Alltel Comments at 9. See also OPASTCO Comments at 16-17.

variety of business conditions, experience variations in operations, and are disproportionately vulnerable to changes in local economies.[1474] In addition, Alltel argues that the diversity of areas served by the small to mid-sized LECs precludes the application of one productivity factor to all.[1475] Several parties recommend a sliding productivity scale with lower numbers applied to smaller companies.[1476] Finally, Alltel and OPASTCO argue that the onus of establishing a different productivity number for small companies should not be placed on the small carriers, who are least able to afford the complex productivity analyses that may accompany such a demonstration.[1477]

iii. Discussion

693. In the Further Notice, our analysis of a range of productivity data led us to conclude that the best estimate of potential annual productivity gain in the telecommunications industry is 2.5 percent over and above the level achieved by the economy as a whole. We continue to rely principally on the long term historical productivity data in setting our LEC industry productivity factor, as we have in setting the AT&T productivity factor. We have discussed at length in Section III of this Order the propriety of relying on long time series productivity data. The same analysis applies to setting a productivity factor for the LECs, and we hereby incorporate that discussion here. Nothing in the current record provides evidence sufficiently strong to persuade us to alter our tentative conclusion in the Further Notice that 2.5 percent is the best estimate of LEC productivity and, therefore, we reaffirm that tentative conclusion.

694. As noted in Section III with respect to AT&T and as we discussed in the Further Notice, much of the long term productivity data in the record concern unified, pre-divestiture Bell System operations. In other words, these data do not distinguish interstate interexchange operations from

---

1474 NRTA Comments at 10.

1475 Alltel Comments at 9-10. See also Florida PSC Comments at 5-6.

1476 PRTC, for example, recommends that BOC productivity be set at 2.3 percent, and that the productivity factor for the smaller carriers gradually decrease to zero. PRTC Comments at 10-13. See also CBT Comments at 19-20; OPASTCO Reply at 16; PRTC Reply at 12-14. Several parties support application of a lower productivity factor to small carriers, without specifically endorsing a sliding scale. Pactel Comments at 63; Rochester Comments at 7; United Comments at 8; Contel Reply at 10-11.

1477 Alltel Comments at 10-11; OPASTCO Comments at 14-15.

interstate local exchange services. This raises the issue of whether such data can serve as a basis for predicting the potential future productivity gains of the divested components of that system. Some commenters advance specific arguments why these data should not be used for predictions and why we should select a different number than suggested by the long term data. As explained hereafter, we are not persuaded by these arguments. We recognize, however, that our analysis of post-divestiture LEC data does not provide the same level of corroboration for our prediction as that provided by our analysis of AT&T post-divestiture data, nor does the current record permit us to preclude the possibility that there may be variations in individual LEC productivity around the industry average. Therefore, we propose the addition of an automatic stabilizer as an additional regulatory backstop to ensure that LEC rates remain within the zone of reasonableness. We turn now to a discussion of our reasons for rejecting arguments for selecting a productivity factor for the LECs that differs from AT&T's, and for proposing an automatic stabilizer.

695. In the Further Notice, we analyzed arguments that AT&T and BOC productivity would differ because of their respective characteristics, such as size, technology in use, technology likely to be brought on line in the foreseeable future, investment patterns, or a comparison of the rates one carrier or group of carriers charges in relation to another carrier or group of carriers. In each instance, we explained why we found such arguments unpersuasive,[1478] and we tentatively concluded that they provided no basis for applying different productivity factors to AT&T and the LECs.

696. The record accumulated in response to the Further Notice contains many of these same arguments. The instant record, however, also reflects the same deficiencies in these arguments that were identified and discussed in the Further Notice. For example, although we fully recognize, and are impressed by, the efficiencies resulting from advances in telecommunications technology in recent years, no commenter has provided empirical evidence that such advances are having or will have a sudden, revolutionary impact on the total factor productivity of the telephone industry as a whole, of AT&T, or the LECs. Indeed, it is unlikely that such evidence exists. Telephone companies provide their services using a large mix of labor, equipment, and materials. Not all of this mix is affected by the technological advancements described by the commenters.

697. Moreover, even that portion of the mix which is the subject of advancement, such as switching equipment, is replaced gradually over time, so the impact on productivity of any particular technological advancement is likely to be realized slowly and steadily, as it is worked into the mix, rather than in an abrupt manner. The long term data indicate that the

---

1478 Further Notice, 3 FCC Rcd at 3409-12 (paras. 390-94).

telecommunications industry has experienced productivity gains in excess of those experienced by the economy as a whole for many decades, as should be expected in an industry marked by steady technological advancement. The record provides no basis to believe that these gains will suddenly cease, even for those companies that have installed what today is considered state-of-the-art technology, nor does the record provide any persuasive evidence that such gains will suddenly accelerate. And, there is no persuasive evidence that the productivity effects of technological advancement are being realized to a greater degree by the LECs relative to AT&T, or vice versa. Therefore, we tentatively conclude here, as we did in the Further Notice, that arguments of this nature, unsupported by empirical evidence, provide no basis for selecting a productivity number that differs from the long term historical number of 2.5 percent relative to the economy as a whole.

698. We recognize, however, that the possibility continues to exist that the 2.5 percent productivity factor may prove unduly burdensome for small telephone companies. This Commission has acknowledged in the past that such companies may have fewer opportunities than larger companies to achieve cost savings and efficiencies, and we have made policy decisions in accordance with this principle.[1479] Unfortunately, there is nothing in the current record to provide specific guidance as to how to measure these differing opportunities and calculate a separate productivity factor for small companies. The Third Bellcore study suggests that a one percent differential may exist between BOC productivity and the productivity of the remainder of the industry, but the non-BOC portion of the industry does not consist entirely of small telephone companies, which makes it difficult to attribute the one percent differential to small companies alone. A similar lack of specific small company data casts a shadow over the conclusion advanced in the Ernst & Whinney study filed by USTA that small companies should have a lower productivity factor because their slower demand growth presents fewer opportunities to move down the cost curve. The difficulty with this study is that it does not measure small company productivity but, instead, presents theoretical arguments about the potential for productivity gains relative to the cost curve contained in the study. The absence of data makes it difficult to test these arguments. For example, if small companies operate in the region of that curve where cost declines faster (even if absolute costs are higher), small demand increases could produce large efficiency gains.[1480]

1479 See, e.g., MTS and WATS Market Structure, Recommended Decision and Order of the Federal-State Joint Board, 2 FCC Rcd 2324, adopted, 2 FCC Rcd 2953 (1987).

1480 Our decision in this Notice to make participation in price cap regulation optional for small telephone companies mitigates our concern that the productivity factor might prove burdensome to this segment of the industry. However, we continue to seek data that could help resolve the uncertainty associated with this issue and, perhaps, result in more small

699. We also recognize that our attempt to corroborate for the LECs the long term productivity number through an analysis of post-divestiture price and cost data has not been as successful as for AT&T.[1481] As discussed in detail elsewhere in this Order, our attempts are based on the simple and well recognized principle that it is possible to calculate a change in the total factor productivity of a regulated firm by calculating a change in its prices.[1482] The task of applying this principle is considerably more complex with regard to the LECs than it is for AT&T, however. This is because changes in exogenous costs must be netted from the price changes under examination, and the LECs experienced far more changes of this nature during the 1984-88 period than did AT&T. Indeed, so many changes occurred that slight differences in the methodology used to account for such changes, or small errors in the data, can lead to significantly different estimates of LEC productivity growth. Moreover, the results seem highly dependent on the choice of starting and ending dates within the 1984-88 period. Apart from questions concerning the treatment of underlying data, this sensitivity to starting and ending dates raises serious questions about the level of confidence that can be accorded to attempts to calculate recent LEC productivity precisely based on the post-divestiture studies and data filed in the record thus far.[1483] In Appendix E to this Order, we discuss these

---

companies exercising their option to participate in price cap regulation.

1481 In the Further Notice, we tentatively determined that attempts to separate pre-divestiture studies into long distance and local components are impracticable. The data simply do not exist in a format that permits such separation. Moreover, we found serious flaws in attempts by commenters to overcome this lack of quality data. Although several interesting attempts at backcasting were submitted in the record, the critical assumptions on which they were based were unsupported or did not withstand analysis. See, e.g., Further Notice, 3 FCC Rcd at 3260-61 (paras. 120-23) (New York DPS backcast of AT&T residential rates during period from 1973 through mid-1987 failed to account accurately for exogenous cost changes that occurred during that period). Nothing in the current record persuades us that attempts to separate pre-divestiture productivity studies would produce accurate productivity estimates.

1482 For a thorough but concise discussion and proof of this principle, see E. Silberberg, The Structure of Economics 309-313 (1978).

1483 The problems we encountered in evaluating historical, post-divestiture changes in exogenous costs should not continue to be a ongoing problem in a price cap system. In major part, these problems result from an inability to obtain quality cost data for the early post-divestiture period, a period marked by implementation of this Commission's access charge plan and several major changes in the separations process. These events not only are nearing

difficulties at length in connection with our analysis of the studies of post-divestiture LEC prices that were filed in the record by Bellcore and AT&T.

700. After review of the record, our conclusions on LEC productivity are as follows: First, long term evidence in the record concerning productivity is the best evidence of historical productivity achievement, and we are persuaded by this evidence that the best estimate of future annual LEC productivity gain is 2.5 percent. Second, attempts to corroborate the 2.5 percent figure by analyzing changes in LEC rates during the 1984-88 period, although well founded in principle, do not appear capable of being used to calculate a precise measure of LEC productivity during this period because of the lack of quality data. Third, although the Bellcore and AT&T productivity studies based on post-divestiture pricing data provide some measure of corroboration for our 2.5 percent estimate, the record at this point does not permit us to use these studies to corroborate our estimate of LEC productivity with the same degree of confidence that our analysis of AT&T's post-divestiture prices lends to our estimate of AT&T productivity. Therefore, we propose to adopt an additional regulatory backstop to our LEC price cap proposal in order to ensure that LEC rates remain within the zone of reasonableness.

(1) Automatic Stabilizer

701. Although we believe that 2.5 percent per year represents a reasonable estimate of potential LEC industry productivity, we recognize that we lack the same level of corroboration of this estimate from post-divestiture data that we have for AT&T. We are attempting to respond in part by being aggressive in our estimate of potential LEC productivity.

702. We recognize as well that the experience of individual LECs may show some statistical variability around the mean performance of all LECs, especially over relatively short periods of time. The third LEC productivity study submitted by Bellcore, for example, calculates a 9 percentage point range in the annual rate of X-factor productivity growth achieved by the seven RBOCs during the period 1984-1988.[1484] Of course, as we have emphasized

---

completion but, as as part of the access charge plan implementation process, we have developed and refined techniques for assembling LEC cost data that will be continued under price caps. See e.g., Section IV.C.1, supra (discussion of use of tariff review plans in conjunction with administration of price cap tariff review process).

1484 Bellcore calculates individual historical RBOC productivity as follows:

Ameritech	1.28 percent per year
Bell Atlantic	-1.26 percent per year
BellSouth	-2.61 percent per year

above, there are serious limitations to all of the studies in the record that attempt to corroborate long term average LEC productivity from an examination of LEC rates during this period. The concerns about such attempts increase with regard to attempts to disaggregate their findings into individual holding company results.

703. As a general matter, the possibility of statistical variability in the experience of individual LECs over short periods of time does not, in our opinion, justify forgoing the benefits of price cap regulation for the LECs and those they serve. Year-to-year variability in achieved productivity is to be expected. While we believe that 2.5 percent is a reasonably accurate measure of industry productivity, we also recognize that we do not have the same level of corroboration for LEC productivity performance in the post-divestiture period as we do for AT&T, and that we cannot preclude, based on the current record, the possibility that individual LECs will consistently under-perform or over-perform in comparison to the industry benchmark. We therefore propose an additional regulatory backstop, given the absence of meaningful competition in LEC markets that otherwise would serve as such a backstop. The purpose of such a backstop would be to keep prices in a zone of reasonableness relative to costs while maintaining incentives for LECs to lower costs and develop new and better services.

704. Under price caps, a LEC's earnings will depend upon its ability to lower costs relative to its price cap index. Apart from exogenous adjustments, our price cap formula would dictate a 3 percent per year reduction in prices relative to the overall inflation rate in the economy. Carriers that are able to lower their costs by 3 percent per year relative to inflation will maintain a constant profit margin and continue to earn the target rate of return in effect when price caps are first introduced. Carriers that are able to lower their costs by more than 3 percent per year will earn more than the target rate, whereas carriers that are unable to lower costs by as much as 3 percent per year will earn less than the target rate.

705. The precise relationship between cost reduction due to growth in productivity and the rate of return earned on investment for an individual LEC will depend upon that LEC's particular cost and capital structure. It is reasonable to conclude, however, that on average a LEC will experience about a

---

NYNEX	-0.19 percent per year
Pactel	0.35 percent per year
SWB	0.99 percent per year
US West	6.59 percent per year

These data show a range of 9.2 points between BellSouth and US West, and a weighted average of 0.62 percent per year for the seven RBOCs. See Bellcore Third Study at 5-7.

0.4 percent change in its rate of return for each 1.0 percent change in productivity relative to economy-wide productivity (and hence each 1.0 percent reduction in costs relative to inflation.[1485] Stated another way, each 1.0 percentage point change in a representative LEC's rate of return is associated with a 2.5 percent change in productivity and cost reduction. Thus, a LEC generally would have to lower its costs in a given year by 5.5 percent relative to inflation, or more than twice the long term historical rate of cost reduction achieved by the average LEC, in order to raise its rate of return by a full percentage point above the rate of return prescribed for LECs continuing under that approach to regulation. A typical LEC that was only able to lower its costs 0.5 percent relative to inflation in a given year would see its rate of return fall one percent below that prescribed rate of return.

706. Over time, a sustained productivity advantage or disadvantage has a cumulative effect on a LEC's rate of return. For example, a representative LEC able to achieve a sustained productivity advantage of 2.5 percent per year over and above the 3.0 percent per year needed to earn the target rate of return would add 1.0 percent per year to its rate of return; a representative LEC with a sustained disadvantage of 2.5 percent per year would see its rate of return drop 1 percent per year. Although we are not convinced by the available data that there are substantial differences among LECs in their underlying ability to meet or beat the 3.0 percent productivity mark, we recognize that short run statistical variability like that suggested by the Bellcore data or an irreducible margin of error in setting the initial target rate of productivity growth may result in some LECs' achieving above-target productivity growth in specific years and others' achieving below-target growth in specific years. Some variability in achieved rates of return is an expected feature of incentive regulation, but such regulation is not meant to reward or penalize carriers on the basis of random differences or errors in setting the productivity factor. Moreover, profits are the instrument for achieving desirable productivity performance, but the ultimate objective of incentive regulation is to achieve lower prices for consumers than they would otherwise achieve, while protecting shareholders against unreasonably low returns on their investment.

1485 Monthly Report data and statutory tax rates suggest that capital is approximately 1.5 times revenue and the marginal tax rate on income is approximately 0.4 for a representative LEC (Wisconsin Bell's MR-1 for December 1987, for example, reports capital of $1.4 billion and income of $0.9 billion for 1987; it does not report a marginal tax rate on income, but its average tax rate, including property taxes, is approximately 0.5). For such a LEC, a one percent increase in productivity would result in a reduction in costs equal to 1 percent of revenue and an increase in after-tax profits equal to 0.6 percent of revenue or 0.4 percent of capital.

707. Based on this analysis, we propose to add an automatic stabilizer as an additional backstop in the LEC price cap plan. We tentatively conclude that under price cap regulation variations in achieved LEC rates of return that lie in a range between two points below and two points above the target rate of return would not be unexpected and would not trigger concern that the price cap formula should be adjusted. Available evidence indicates that this plus or minus 2 percent deviation from the authorized return is in line with the earnings experience of comparable firms operating under competitive conditions; that is, the kinds of conditions we seek to replicate under price cap regulation. For example, among the evidence we reviewed in our last order prescribing a rate of return for the LECs were rates of return computed several different ways for 47 companies comparable to the LECs.[1486] The standard deviation of these rates of return is approximately 1.8 percent. Assuming that the distribution of rates of return for these companies is comparable to the distribution one would expect to see among the LECs, a band of plus or minus 2 percent around the average rate of return should encompass approximately 73 percent of all companies. We seek comment on the use of these data as the basis for establishing the parameters of our proposed stabilizer.

708. We propose that within this range (i.e., the authorized return, plus or minus 2 percent), carriers keep, for tariff review purposes, all the gains from above-average performance and bear all the risks of below-average performance during the initial four years of the plan. We also tentatively conclude that, for tariff review purposes, consumers should share in the benefits of above-average performance outside this range and, in return, should bear some of the risk of below-average performance outside this range. Accordingly, we propose to adjust each LEC's price cap index based on deviations of the rate of return actually realized by that LEC from the range described above. We propose to make such an adjustment at the time of the annual revision of LEC access tariffs. We propose to make the adjustment in a manner that would bring the LEC's price cap index to a level in line with its earnings range.[1487] The mechanism is prospective in application.

1486 Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Memorandum Opinion and Order, CC Docket No. 84-800, Phase III, FCC No. 86-354, released Aug. 25, 1986 at App. B.

1487 For example, assume initial price cap tariffs take effect on July 1, 1989. Assume further that the authorized return for carriers subject to rate of return regulation is 12 percent. In keeping with the general price cap plan outlined in this Order, LECs would revise their tariffs on an annual basis, as is the case today. In this example, therefore, they would file proposed tariff revisions on April 1, 1990, which would include calculations of base period weights and a demonstration that they have complied with all applicable cap requirements (e.g., banding restraints, formulas). As part of

The carrier would not be required to refund any of its profit, nor would it be provided an opportunity to recoup earnings shortfalls. Its PCI would be adjusted prospectively to reflect the higher or lower degree of productivity in fact achieved.

709. This automatic stabilizer will serve as a backstop that assures that the price cap plan for the LECs will lead to reasonable rates for LEC interstate services. During the initial implementation period for a new form of regulation, we conclude that it is prudent to err in the direction of including safeguards to protect ratepayers and shareholders. If a safeguard subsequently proves to be unneeded, it can be removed. As we gain experience with price cap plan, and that experience boosts confidence in the details of that plan, including our ability to set a productivity factor that reflects a reasonable estimate of projected productivity growth, it may become possible to eliminate the automatic stabilizer. Until we gain such experience, however, we tentatively conclude that inclusion of safeguards in our price cap plan for LECs is in the public interest.

710. We believe that our proposed automatic stabilizer does not eliminate the incentives created by the price cap regime to operate increasingly efficiently. It must be recognized, however, that the mechanism would dampen at a certain level of achieved productivity the incentives on which the success of price cap regulation is premised.

711. As an alternative to the stabilizer, we propose to conduct our comprehensive performance review of price caps for LECs in late 1992. Such a review could serve the same safeguard role as a stabilizer -- because it would present us with an opportunity to examine the application of price caps to the LECs and to make any necessary adjustments -- but may have less of an effect on the consumer-oriented efficiency benefits price cap regulation is intented to generate. For this reason, we propose as a substitute to the stabilizer this earlier performance review of price caps as applied to the LECs.[1488] We seek comment on this alternative proposal. We also seek

---

this demonstration, each LEC would report its actual, total interstate return during the base year (here, calendar year 1989). If that return falls within the range of 10 percent to 14 percent, no automatic stabilizer adjustment would be necessary. If the carrier reports earnings of 9 percent during the base period, for example, an adjustment would be made to the carrier's current PCI, raising it to the point at which it would have had to have been set on July 1, 1989, in order for the carrier to have earned 10 percent during the base year. At that point, the price cap formula would be applied to each of the three LEC price cap baskets.

1488 The review discussed in the text would begin after two years' experience with price cap regulation for LECs, as opposed to the three year timetable for initiation of a comprehensive review that was proposed in the

comment on the specific parameters we might need to establish to guide such a review.

712. We tentatively conclude that there is ample precedent to support our authority to adopt the price cap proposal we present in this Further Notice, of which the automatic stabilizer is but one component. We tentatively find that this proposal, and in particular, the manner in which it takes account of a carrier's costs and profits, will permit us to discharge our statutory obligation of assuring just and reasonable rates. We premise our conclusions on a number of elements of the plan, including the stabilizer, which should produce carrier rate levels within a zone of reasonableness. First, the plan calls for initial rates to be based upon existing rates, which have been filed, reviewed, and become effective under our current regulatory regime.[1489] Second, the plan's adjustment formula accounts for changes in economy-wide costs (the GNP-PI factor); industry-wide costs (the productivity factor) and individual carrier costs (the exogenous factors) Third, we now propose to add an additional factor, the automatic stabilizer or an equivalent short term review, which would function as an additional safeguard against rates straying from the zone of reasonableness. Ongoing monitoring of individual carrier costs followed by a comprehensive review of our price cap plan would supplement the protection afforded by the automatic stabilizer. Our proposal to conduct a comprehensive review, discussed at greater length subsequently,[1490] would examine, among other things, the relationship between costs, rates, and profits. Finally, tariff investigations under Section 204 and the Section 208 complaint process will continue to require our evaluating carriers' rates in light of their costs and profits. Thus the proposed regime should operate to detect when rates have fallen outside the zone of reasonableness, and to correct for this failing by driving them back within the zone.

713. We seek comment on our proposal to establish an automatic stabilizer and the means described above through which it would be

---

Further Notice and that we have adopted elsewhere in this Order relating to AT&T price cap regulation. Although there continues to be a possibility of implementing price caps for LECs in conjunction with a limited access filing that would occur in the fall of 1989, to be effective January 1, 1990, it is more likely that implementation would occur in conjunction with the next currently scheduled review of the LECs' annual access tariff revisions, which will be filed April 1, 1990, to become effective July 1, 1990. Therefore, assuming a July 1990 implementation date, the review discussed in the text would occur in the latter part of 1992.

1489 See Section IV.C.3.d.i.

1490 See Section IV.F, supra.

incorporated in the price cap formulas governing LEC baskets. We seek comment on our alternative proposal of shortening the time period between the initiation of caps and the first review of price caps for LECs. We also seek comment on our tentative conclusion that inclusion of the stabilizer in our proposal, or the alternative of a review after a short period of experience under price cap regulation, would lead to just and reasonable rates. Commenters making an alternative proposal should explain how their proposal would meet the purpose for which the automatic stabilizer was created and would strike a better balance between maximizing a carrier's incentives to operate efficiently and protecting ratepayers. We also seek comment on other ways to amend our LEC price cap proposal to compensate for any shortcoming of the productivity factor to bring rates within a zone of reasonableness. In particular, we seek comment on whether we should have an additional refund mechanism to achieve this result. Those supporting such a refund mechanism should discuss how this mechanism is consistent with the court's decision in American Tel. & Tel. v. F.C.C.[1491]

714. For those commenting on the automatic stabilizer, we clarify that we are not proposing to prescribe in this docket a specific rate of return about which the bands are to be centered. Instead we propose to rely on the periodic Part 65 represcription process to set the point around which the bands were centered. Thus, under our plan, the rate of return periodically represcribed under Part 65 would continue to define the earnings at which carriers remaining subject to rate of return regulation should target their interstate service rates and to impose a direct constraint on the allowed earnings of those carriers. At the same time, it would be used to determine whether and how much a carrier under price cap regulation would, for tariff review purposes, have to adjust its price cap indexes to share excess earnings with its customers. Therefore, although price cap LECs would be subject,

---

1491 836 F. 2d 1386. In that case, the Court reviewed and remanded to this Commission our Part 65 rules establishing an automatic refund mechanism triggered by a carrier's earning in excess of a prescribed return during the period in which that prescription was in effect. Finding the refund provisions to be "inconsistent with the rate of return prescription it purport[ed] to enforce," the Court held the rule to be arbitrary and capricious because it required a carrier to refund any earnings above the prescribed return plus a prescribed buffer, but did not permit the carrier to recoup shortfalls in earnings below the target. Id. at 1390. The Court had understood the rate of return prescribed by this Commission, and against which this Commission proposed to measure the carrier's refund liability, to be the minimum rate this Commission could prescribe that would still be sufficient to permit the carrier to cover the cost of capital it must raise to be able to do business. The Court noted that with the refund rule, the carrier over the long run was virtually guaranteed to fall short of earnings it required to meet its cost of capital.

for tariff review purposes, to the constraint on earnings and prices imposed by the price cap formula, and would not be subject to the prescribed rate of return, the prescription would be used as a reference point for adjusting price cap indexes for tariff review purposes. Moreover, the price cap regime proposed herein would require those LECs subject to it to assume the risk that certain costs for which the price cap formula made no explicit adjustment could be recovered without raising prices above the predetermined caps. We tentatively conclude that with such heightened risks there should come a concomitant opportunity for greater reward. We seek comment on all these tentative conclusions relating to our use of the rate of return prescribed under Part 65 for these dual purposes.[1492]

(2) Common Line Adjustment

715. Our decision to propose the inclusion of an automatic stabilizer in our price cap plan for LECs is based in part on our tentative finding that record evidence, including studies of LEC post-divestiture productivity submitted by Bellcore and AT&T, does not provide the same level of corroboration for our estimate of LEC productivity as we have for AT&T. This record evidence, however, does provide some measure of corroboration. For example, as we discuss in Appendix E, adjusting the Bellcore and AT&T to correct for errors would cause the results of those studies to collapse into a range that includes our own long term estimate of 2.5 percent. More importantly for present purposes, our examination of these studies illuminates a relationship between the calculations of the specific LEC productivity numbers contained in those studies and the manner in which LECs have recovered their common line revenue requirement since the initiation of access charges in 1984. We turn now to a discussion of our tentative conclusions regarding the recovery of common line costs under our price cap proposal for LECs.

1492 We note that the rules governing that process are now the subject of review in another docket. See Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communications and Local Exchange Carriers, CC Docket No. 87-463, 2 FCC Rcd 6491 (1987). It is conceivable that at some future date we might explore, in the context of our rate of return represcription processes, the idea of formalizing the proposal discussed in the text by prescribing a banded rate of return for LECs. This would represent a fundamental change in the underpinnings of price cap regulation as we have developed it to date, which currently takes the form of rules for use in evaluating proposed tariff revisions. Should we decide to pursue this idea, we would, of course, initiate such a proceeding through the adoption of a Notice of Proposed Rulemaking.

716. The LECs' common line revenue requirement consists principally of the interstate portion of the cost of providing the local loop between an end user's premises and a local telephone company's central office.[1493] These costs are by nature non-traffic sensitive; that is, they do not vary in direct proportion to usage. A portion of common line revenue requirement is recovered by LECs directly from end users in the form of surcharges on special access lines and from a flat rate charge, known as the subscriber line charge, that telephone subscribers are assessed each month on a per line basis.[1494] LECs recover the residual portion of the common line revenue requirement from interexchange carriers, however, on the basis of a charge per access minute of use known as the carrier common line (CCL) charge.[1495]

717. Under our current access charge rules, the CCL charge is particularly sensitive to the level of demand because it is determined by dividing a LEC's total minutes of demand for common line service into a revenue requirement that does not fluctuate directly in accordance with demand. Thus, a LEC's marginal cost of providing an additional minute of service over common line facilities approaches zero, while each additional minute of demand translates directly into decreases in the CCL charge.[1496]

718. In the Further Notice,[1497] we recognized that such unique properties might have an effect on developing an appropriate price cap formula for the LECs. Therefore, in order to ensure that LEC rates subject to price caps would be adjusted pursuant to accurate and meaningful measurements of LEC

1493 For a complete description of the common line revenue requirement, see the Further Notice, 3 FCC Rcd at 3288-89 and notes therein.

1494 See 47 C.F.R. §§ 69.104, 69.115. The level of the subscriber line charge is determined by Commission rule. After the final adjustment to residential and single line business subscriber line charges takes affect as scheduled on April 1, 1989, such charges will be capped at a level of $3.50 per line and remain fixed thereafter.

1495 See 47 C.F.R. § 69.105.

1496 As noted previously, the unique properties of recovering common line costs, coupled with the many exogenous changes affecting the common line revenue requirement during the period 1984-88, complicate the process of seeking corroboration of LEC productivity levels through an examination of LEC rates during that period. Indeed, four of the six major areas of dispute associated with the Bellcore and AT&T productivity studies wholly or partially relate to the treatment of common line costs. See Appendix E.

1497 See Further Notice, 3 FCC Rcd at 3288-93 (paras. 180-88).

common line productivity, we proposed to use a total common line rate per minute in the PCI formula (which would be computed as if there were no end user charges) rather than using the CCL charge. This total common line rate per minute would relate more clearly to changes in demand, productivity, and inflation than would the existing CCL calculation. We proposed that carriers also be required to compute an end user change per minute. The CCL charge under price caps would then be adjusted as the difference between the common line and end user per minute charges.[1498]

719. After reviewing the comments, we continue to believe that the primary proposal described in the Further Notice is the best way to account for the fact that the common line revenue requirement is recovered from a combination of the CCL charge and the subscriber line charge. We reaffirm our tentative conclusion that the price cap formula should apply to the total common line rate per minute and that the CCL price limit should be computed as the difference between the common line price per minute and the end user price per minute.

720. We also tentatively concluded in the Further Notice that this proposal, coupled with our proposal to require that CCL charge reductions attributable to demand stimulation resulting from exogenous cost changes be treated as exogenous, would adequately accommodate for the unique characteristics of common line cost recovery. As an alternative, we proposed to use an index of the price per line, rather than the price per minute, as the common line component of the PCI.

721. Our alternative proposals to cap common line rates on a per minute or per line basis attracted support from two divided groups of interested parties. The LECs strongly favor the continuation of a per minute approach because, they argue, the benefit of demand growth in lowering unit costs is reflected already in the productivity factor component of the price cap formula.[1499] Another group of commenters argued just as strongly that a per minute cap would not account adequately for demand growth but would instead unfairly penalize consumers of LEC common line services.[1500]

1498 See id. at 3292-93.

1499 See, e.g., Bell Atlantic Comments at 17; BellSouth Comments at 54-56; Centel Comments at 16-17; USTA Comments at 27-28; NYNEX Comments at 46-47.

1500 See, e.g., AT&T Comments at 57-58; Such commenters contend that this Commission's proposal to adjust common line rates for exogenous demand stimulation would not account fully for demand growth. See, e.g., New York DPS Comments at 25.

722. We believe that a measure of truth exists in the arguments of both groups of commenters. We agree with those commenters who claim that some of the growth in minutes per line must be considered exogenous. Indeed, this Commission has a long-standing policy of ensuring that the effects of regulatory actions on demand be reflected in rate adjustments, and we proposed in the Further Notice to continue this policy under price cap regulation.[1501] On the other hand, the LECs also are correct in stating that the growth in minutes per line is embedded in the long term Bell System productivity studies that form the foundation of our calculation of historical productivity achievement in the telecommunications industry.

723. Our objective is to establish a cap for the common line basket that is consistent both with the productivity factor we have derived from the long term Bell System studies and with our policy that rates be adjusted to reflect exogenous demand stimulation.[1502] The observed total factor productivity is composed of a combination of cost reductions due to demand growth (from economies of scale or higher capacity fill rates) and of cost reductions due to improved production methods for the same volume of output. For access elements other than common line, demand growth causes some increased cost, though not necessarily a proportional increase in cost. The unique characteristic of common line is that costs do not vary at all with changes in demand (i.e., growth in minutes of use per line). Neither the per line nor the per minute approach properly relates the special characteristic of common line to the historical productivity studies. Therefore, we propose a combination of the two measures in an attempt to adapt the historical measures to the prediction of common line productivity, consistent with our policy concerning exogenous demand stimulation.

724. With the per minute approach, the change in the common line price cap would be given by the term (GNP-PI - x), as it is in the other baskets. With the per line approach, the change in the common line price cap would be given by the term (GNP-PI - x - g)/(1 + g), where g is the rate of growth of common line minutes per line.[1503] Therefore, in accordance with our tentative decision to use the simple average of the two formulas, we propose that the common line adjustment factor should be:

$$[(GNP\text{-}PI - X) + (g/2)(GNP\text{-}PI - X - 1)] / (1 + g)$$

1501 Further Notice, 3 FCC Rcd at 3291 and notes therein.

1502 The importance and difficulty of this task are heightened given our determination to place common line rates in a separate basket.

1503 See Appendix F for derivation.

725. The PCI formula for the common line basket is, therefore:

$$PCI_t = PCI_{t-1}[1 + w\ [(GNP\text{-}PI - X) + (g/2)(GNP\text{-}PI - X - 1)] / (1 + g) + \Delta Z/R].$$

726. We seek comment on our tentative decision to resolve uncertainty concerning potential LEC productivity arising from the relationship between demand growth and common line NTS costs through the application of this adjustment to the PCI formula applied to the common line basket. We also seek comment on our tentative conclusion that the application of this adjustment makes it unnecessary to make the separate adjustment for exogenous demand stimulation described in the Further Notice.

d. Consumer Productivity Dividend

727. In a LEC price cap plan, the consumer productivity dividend (CPD) would play the same role that it plays in the AT&T plan we have adopted. The CPD format is a tool to assure that ratepayers share in a tangible way in the benefits flowing from price cap regulation. Set too low, the CPD might not bring ratepayers low rates; set too high, it may drop LEC earnings below the zone of reasonableness. In Section III we expressed our conviction that "a CPD of 0.5 percent provides the best balance of shareholder and ratepayer interests "[1504] for AT&T. We find nothing in the record to support a different conclusion for LECs. No commenter has offered data to support our adopting a CPD lower or higher than the 0.5 percent we proposed in the Further Notice for the LECs. Consequently, we tentatively conclude that the price cap formula for the LECs should also include a 0.5 percent Consumer Productivity Dividend. We seek comment on this proposal as well as the factors we have identified that might warrant our raising or lowering that figure.

728. US West suggests that the validity of the Consumer Productivity Dividend turns on the voluntariness of the price cap plan for LECs.[1505] We disagree. The CPD is only one of several factors comprising a price cap formula upon which this Commission would propose to rely on to identify those rate filings to which streamlined tariff review should attach, that is, those rates which we may reasonably presume to be just and reasonable for tariff review purposes. Its validity does not depend upon whether the price cap plan is mandatory or voluntary.

729. In the Further Notice we sought comment on whether, instead of incorporating the CPD as a factor to be included in the calculation of the

---

1504 Further Notice, 3 FCC Rcd. at 3405 (para. 378).

1505 Id. at 3407 (para. 385).

annual price cap index, the value of the CPD during the period from introduction of price cap regulation until the completion of the comprehensive performance evaluation should be flowed through to consumers through a rate cut effective on the first day of the plan. Comments addressing this alternative proposal do not convince us that this is necessary to assure that consumers realize benefits from the proposed change to our regulatory regime.[1506] Accordingly, we tentatively conclude that the Consumer Productivity Dividend should not be realized through an upfront adjustment.

e. Operation of the PCI

i. Frequency of Adjustments

(1) Summary of Further Notice

730. In the Further Notice, we proposed that the PCI for LECs, like that for AT&T, be adjusted annually to reflect inflation, changes in productivity, and changes in specified exogenous costs.[1507] We tentatively determined that annual adjustments would adequately reflect cost changes, while avoiding potential rate churn.[1508]

(2) Pleadings

731. As discussed in Section III.C.1.e.i.(2), supra, several commenters advocated that AT&T's price cap adjustments be made more often than once per year, primarily because of anticipated mid-year changes in the access charges that AT&T would have to pay the LECs. No general objections were expressed to annual adjustment of LEC PCIs.

(3) Discussion

732. Due to the large access component of its costs, AT&T is probably more likely than the LECs to experience mid-year exogenous cost changes. Nevertheless, we tentatively conclude that our decision to require updating of AT&T's PCI to reflect exogenous cost changes, is in principle equally germane to LEC price caps. Moreover, we believe we ought not to allow the LECs to wait until the next annual price cap filing to reflect exogenous cost changes when we require AT&T to update its PCIs to reflect exogenous cost changes occurring mid-year. Thus, we propose to impose the same PCI updating

---

1506 Id. at 3407-08 (para. 386).

1507 Further Notice, 3 FCC Rcd at 3427 (paras. 427-28).

1508 Id. See also Section III.C.1.e.i, supra.

and filing obligations on the LECs as we have adopted for AT&T.[1509] As with AT&T, we also tentatively conclude that the LECs should make adjustments for inflation and productivity on an annual basis. In addition, we propose that the LECs make any necessary stabilizing adjustments (described in Section IV.D.1.c.ii, infra) to their PCIs at the time of the annual price cap filing.

ii. Adjustment Mechanism

(1) Summary of Further Notice

733. The Further Notice did not differentiate between AT&T and the LECs in the design of the PCI formula. As described in Section III.C.1.e.ii.(1), supra, the proposed formula provided for index adjustments to reflect changes in the costs of factors of production, productivity changes, access cost changes, and other specified changes in exogenous costs. Since most LEC interstate basic service offerings would not have an access cost component, as applied to the LECs the access cost variable ("Y") in the proposed formula would simply have a value of zero in most instances (LEC MTS services being an exception).

(2) Pleadings

734. Apart from a claim by Pactel that we should specify that the "Y" adjustment variable for access costs in the PCI formula applies only to AT&T,[1510] the record contains no LEC-specific comments regarding the mechanics of the PCI proposed in the Further Notice. The general comments regarding the the mechanics of the proposed PCI formula, which are summarized in detail in Section III.C.1.e.ii.(2), supra, point to problems in measuring accurately exogenous cost changes that occur in the middle of a base period.

(3) Discussion

735. As we discuss in Section IV.C.1.c, supra, we propose special adjustments to the PCI in the case of earnings above or below defined levels, and in connection with the common line basket. In other respects, however, we tentatively conclude that the basic adjustment formula that we are adopting for AT&T should be used in the LEC price cap plan as well.

736. As in the AT&T plan, the exogenous cost factors in the PCI formula track changes on a firm-specific basis, and there is no global exogenous cost adjustment calculation applicable to the industry that has relevance to our proposal. As a general rule, our approach to calculating exogenous

---

1509 See Section III.C.1.e.i.(3), supra.

1510 Pactel Comments at 41-42.

adjustments will be to compare a carrier's historical cost experience with the costs it would have experienced during the same period if the input cost levels (e.g., for purchasing a unit of access, or for amortizing reserve deficiencies) and regulatory environment (e.g., USOA, separations rules) anticipated in the upcoming year had been in effect during the base period.

737. The individual LEC adjustments necessarily will be dependent, for the most part, upon carrier-specific cost and revenue data that must be furnished by the carriers themselves. Our task under price caps, as is the case under existing regulation, will be to scrutinize the carriers' filings to ensure that specified cost changes are flowed through to the PCIs. To aid in that task, we are planning to build a computerized database to verify the accuracy of certain exogenous changes, such as those related to separations. In addition, we intend to continue our practice of establishing tariff review plans that specify the type and format of data that must accompany annual tariff filings. Moreover, this Commission will, as a matter of course, monitor changes in the GNP-PI and regulatory changes that may affect carrier costs.

738. Through administration of the access charge system, this Commission has gained substantial experience in examining the manner in which costs are flowed through into rates, including experience with evaluating the effects of rules changes on carrier costs. In connection with the 1988 Annual Access Tariff Filings, for example, carriers were required to submit data conforming to tariff review plan requirements established by the Common Carrier Bureau demonstrating the revenue requirement impacts of the Tax Reform Act of 1986, inside wire amortizations, and recent changes in the Separations Manual and the USOA. The Common Carrier Bureau used the data it obtained pursuant to the tariff review plan to evaluate carrier costs and to reduce unreasonable rates.[1511] The tariff review plan will continue to play a central role in reviewing price caps. Moreover, the process of ensuring that exogenous adjustments are made should be simpler and more reliable under price caps than our evaluation of annual filings under the current rate base regime, since the price cap calculations primarily involve the use of historical cost data, rather than estimates and projections concerning future operational results.

1511 See Annual 1988 Access Tariff Filings, Memorandum Opinion and Order, 3 FCC Rcd 1281 (1987). Annual 1988 Access Filings, CC Docket No. 88-1, Memorandum Opinion and Order, FCC 88-420, released Dec. 27, 1988.

2. Application of the PCI to LEC services

a. Service Exclusions

i. Summary of Further Notice

739. In the Further Notice we proposed to cap all LEC services, with the exception of individual case basis (ICB) and special construction services.[1512] We stated that special construction tariffs typically involve either long term offerings or a one-time non-recurring charge, and that ICB tariffs involve individualized pricing and long term arrangements. In these cases, capping appears to be superfluous.[1513] We also tentatively concluded that ICB tariffs may raise issues of discrimination of the type that price cap regulation does not purport to treat in a streamlined fashion. We proposed to subject ICB and special construction tariffs to conventional, rather than streamlined, review.[1514] In addition, we tentatively decided that revenues from excluded services should be held separate from capped revenues for performance review purposes, and that these services should continue to be subject to rate of return reporting requirements.[1515]

ii. Pleadings

740. Most carriers and users support the exclusion of ICB and special construction services from price cap regulation.[1516] There appears to be less consensus on the tariff review standard that should apply to excluded services. Pactel and GTOC support conventional review,[1517] while Bell Atlantic argues for streamlined review,[1518] and the Executive Agencies

---

1512 Further Notice, 3 FCC Rcd at 3317 (para. 223).

1513 Id. at 3319 (para. 227).

1514 Id. at 3318 (para. 225).

1515 Id. at 3319 (para. 228).

1516 See Bell Atlantic Comments at 8 n.17; NYNEX Comments at 49; Pactel Comments at 21; SWB Comments at 14; GTOC Comments at 12-13; USTA Comments at 26; Michigan PSC Comments at 18; ICC Comments at 7-8; CBT Reply at 9; API Reply at 21-22; Rochester Reply at 19.

1517 Pactel Comments at 21; GTOC Comments at 12-13.

1518 Bell Atlantic Comments at 12-13.

support forbearance.[1519] Several LECs argue that separate reporting of revenues and expenses for excluded services is unduly burdensome.[1520] Pactel contends that LECs should be permitted to include these revenues and costs for the purposes of their annual rate of return reports and price cap performance reviews.[1521] However, Michigan PSC argues that LECs should be required to report revenues and expenses for excluded services by individual service categories.[1522] In addition, the Networks contend that this Commission should require LECs to report revenues and expenses for special construction in order to monitor the reasonableness of charges, and detect cost shifting from standard part time television to special construction.[1523]

741. In addition, individual parties raise other issues. EDS questions how the pending investigation of ICB DS3 rates will be resolved.[1524] ICC argues that in the event that an ICB service becomes generally tariffed, it should be treated as a new or restructured service.[1525] MCI contends that the exclusion of some services from the price cap will enable LECs to shift costs between services.[1526] Michigan PSC argues that the exclusion may permit the carrier to move an existing service into an exempt service category, rename the service, and provide it at a different price. Michigan PSC also argues that there should be a separate procedure for allocating costs to exempt categories. Finally, Michigan PSC contends that at the expiration of existing contracts, contract-type services should be brought under the price cap.[1527]

1519 Executive Agencies Comments at 21.

1520 NYNEX Comments at 49; Pactel Comments at 21-23; GTOC Comments at 13; USTA Comments at 26; Rochester Reply at 19-20.

1521 Pactel Comments at 22.

1522 Michigan PSC Comments at 18.

1523 Networks Reply at 23.

1524 EDS Comments at 16-17.

1525 ICC Comments at 8.

1526 MCI Comments at 24-25.

1527 Michigan PSC Comments at 18-19.

iii. Discussion

742. We tentatively conclude that although capping all existing LEC services would yield the greatest benefit as a general, theoretical matter, some services are structured and priced in such a way that applying a price cap structure to them would be excessively difficult.[1528] For example, prices of services that consist of long term contracts or one-time non-recurring charges would not be driven down by the operation of the formula and inclusion of these services might give LECs a means of raising the prices of other services. Therefore, we adhere to our tentative conclusion that special construction and ICB services should be excluded from price cap regulation. In addition, we tentatively decide that these services should be subject to conventional tariff review. As we stated in the Further Notice, ICB services raise issues for which streamlined review may not be suitable.[1529] We tentatively conclude that LECs should report non-price cap revenues and costs on an aggregated basis for purposes of both annual reporting and the performance review. We tentatively conclude that this arrangement of reporting on an aggregated basis will adequately address customer concerns regarding cost shifting without subjecting carriers to unduly burdensome reporting requirements.

743. EDS has raised the question of the resolution of the ICB/DS3 investigation.[1530] We are proceeding expeditiously to resolve that investigation, and anticipate that it will be complete before price cap regulation for LECs is implemented. Finally, ICC argues that when an ICB service becomes generally tariffed it should be treated as a new or restructured service. We tentatively conclude that it should be treated as

---

1528 We reiterate that the price cap plan we propose affects only federally tariffed offerings. As we stated in the Further Notice, we do not intend to affect previously enunciated principles applicable to bilaterally negotiated contracts between a LEC and a mobile service provider. Further Notice, 3 FCC Rcd at 3319-20 (para. 230).

1529 The Executive Agencies propose that this Commission forbear from regulating excluded services. As we have addressed this argument with regard to AT&T, and conclude that the analysis is identical with regard to the LECs, we will not repeat it here. We will continue to exercise our full regulatory authority over services excluded from the cap. For a discussion of the Executive Agencies' proposal, see Section III.C.2.a, supra.

1530 See Local Exchange Carriers' Individual Case Basis DS3 Service Offerings, Order Designating Issues for Investigation, CC Docket No. 88-136, 3 FCC Rcd 2582 (1988). See also Supplemental Order Designating Issues for Investigation, CC Docket No. 88-136, 3 FCC Rcd 6066 (1988).

a new service, as of the effective date of the tariff revisions that make it generally tariffed.[1531]

b. Baskets and Bands

i. Summary of Further Notice

744. In the Further Notice, we proposed two baskets for the LECs: a basket for switched access services, and a basket for all other services, which would be dominated by special access. We stated that this arrangement appears to provide carriers with sufficient flexibility to innovate and price efficiently, while ensuring continued protection for ratepayers.[1532] In the Further Notice we also sought comment on the desirability of further disaggregation of special access services.[1533] Finally, we proposed 5 percent upper and lower bands on rate elements, which we said would permit carriers to adjust to new conditions without causing undue pricing dislocations.[1534]

ii. Pleadings

745. In general, LECs favor one basket, and broader bands, while LEC customers propose an increase in the number of baskets, and narrower bands. LECs argue that all services should be in one basket,[1535] and offer several reasons for reducing the number of baskets to one. Some carriers argue that

---

1531 For a full discussion of the mechanics of capping a service formerly priced on an individual case basis, see Section IV.C.5, infra.

It appears that the Michigan PSC intended its arguments in the area of excluded services to apply to both AT&T and the LECs. As we have addressed the issues raised by Michigan PSC in the AT&T section, and do not believe that the issues apply differently to the LECs, we do not repeat our discussion of these issues, but tentatively reach the same conclusions for the LECs that we reached for AT&T. See Section III.C.2.a, supra.

1532 Further Notice, 3 FCC Rcd at 3353-54 (para. 282).

1533 Id. at 3354-55 (para. 283).

1534 Id. at 3356-57 (paras. 286-87).

1535 See Ameritech Comments at 14-15; BellSouth Comments at 39; NYNEX Comments at 30; Pactel Comments at 35; SWB Comments at 16; CBT Comments at 15; Centel Comments at 7; SNET Comments at 17; PRTC Comments at 14 n.7; USTA Comments at 34; Contel Reply at 4-5; Rochester Reply at 13; United Reply at 6.

productivity may vary across baskets.[1536] Carriers also contend that switched and special services are cross-elastic,[1537] and that one basket is necessary to give carriers the flexibility to price efficiently.[1538] Pactel and NYNEX argue that one basket would eliminate the need to allocate exogenous changes.[1539] BOCs argue that it is not necessary to have more than one basket to forestall cross-subsidization, because they have no incentive to cross-subsidize,[1540] and in any case Commission rules and the antitrust laws would prevent cross-subsidization.[1541] Finally, NYNEX argues that further disaggregation of special access services would be more burdensome than existing Part 69 rules.[1542] A few LECs, while favoring one basket, state that they would not object to the two baskets proposed in the Further Notice.[1543] NTCA, however, argues for separate baskets for common line and traffic sensitive switched services, in order to avoid introducing incentives to rearrange the relative prices of common line and traffic sensitive elements. In addition, NTCA states that a separate common line basket will permit NECA to determine the theoretical nationwide average carrier common line (CCL) rate.[1544]

746. Large users, interexchange carriers, and states all argue for a greater number of baskets.[1545] Ad Hoc argues that the proposed baskets are

---

1536 See Ameritech Comments at 14-15; NYNEX Comments at 31; SWB Comments at 19; SNET Comments at 16-17; USTA Comments at 34.

1537 See Ameritech Comments at 16-17; BellSouth Comments at 41; NYNEX Comments at 31-32; SWB Comments at 17; Rochester Reply at 13; USTA Reply at 24.

1538 BellSouth Comments at 40; NYNEX Comments at 31; SWB Comments at 16; Centel Comments at 7; CBT Reply at 8; Rochester Reply at 14; SNET Reply at 13; United Reply at 8.

1539 Pactel Comments at 35; NYNEX Reply at 8.

1540 BellSouth Comments at 45; Pactel Comments at 36.

1541 Ameritech Comments at 17; SWB Comments at 21.

1542 NYNEX Comments at 18.

1543 See Bell Atlantic Comments at 8; Pactel Comments at 35; CBT Comments at 15 (two baskets are acceptable for initial price cap period); Centel Reply at 11-12.

1544 NTCA Comments at 14.

1545 See Ad Hoc Comments at 39; Arinc Comments at 3-4; EDS Comments at 10;

too broad and give LECs too much flexibility.[1546] Customers argue that LECs will use this flexibility to cost shift, price strategically, manipulate equipment sales, or cross-subsidize.[1547] Illinois, TCA, and interexchange carriers argue that the proposed baskets would permit LECs to discriminate among customers.[1548] AT&T also contends that a separate common line basket would facilitate adjustments unique to the CCL rate.[1549]

747. Parties offer the following specific proposals for further disaggregation. Ad Hoc proposes two switched baskets, and three special baskets: high capacity, voice grade, and all other.[1550] AT&T and ICA favor the three special access baskets proposed by Ad Hoc, as well as three switched baskets: common line, transport, and switching.[1551] IDCMA proposes five special access baskets: analog, voice grade, subrate DDS, 56 Kbps DDS, and high capacity.[1552] The Networks request a separate basket for television service.[1553] Finally, ICC proposes switched, interexchange, and special baskets, with "subbaskets" for DDS, voice grade, high capacity, and DS3.[1554]

ICA Comments at 24; IIA Comments at 3-5; Networks Comments at 21; TCA Reply at 14-15; ALC Comments at 8-9; AT&T Comments at 60; Comptel Comments at 6; MCI Comments at 38; Illinois Comments at 19; New York DPS Comments at 16; Ohio PUC Comments at 12; ICC Comments at 7. See also API Comments at 17-18; IDCMA Comments at 45; TCA Comments at 20; Michigan PSC Comments at 13 (arguing for service-specific caps).

1546 Ad Hoc Comments, ETI Report at 42; Ad Hoc Reply at 11.

1547 See Arinc Comments at 3-4; IDCMA Comments at 44; IIA Comments at 3-5; API Reply Comments at 13; ICA Reply at 7-8; AT&T Reply at 86-87; EDS Comments at 10-11; Networks Comments at 21; ALC Comments at 8-9; TCA Reply at 14.

1548 AT&T Comments at 65; Comptel Comments at 14, 16; MCI Comments at 38; Illinois Comments at 19; TCA Reply at 14.

1549 AT&T Comments at 60-61.

1550 Ad Hoc Comments at 39. Ad Hoc does not specify the nature of the two switched baskets.

1551 AT&T Comments at 64; ICA Comments at 24.

1552 IDCMA Comments at 45.

1553 Networks Comments at 21.

1554 ICC Comments at 9.

748. With regard to bands as well as baskets, the LECs favor looser restrictions, while LEC customers propose tighter upper bands. LECs argue that bands should apply to service categories, rather than rate elements.[1555] In addition, LECs argue that lower bands are unnecessary and could injure customers.[1556] Ameritech, BellSouth, and NYNEX contend that the bands in the special access basket should be broader.[1557] NYNEX, Pactel, and Rochester argue that this Commission has encouraged LECs to bring rates for non-recurring charges up to cost, and that 5 percent bands would inhibit the process.[1558] LECs offer a number of specific banding proposals. Ameritech, BellSouth, and NYNEX favor upper bands only, 5 percent for switched access services, and 10 percent for special access services.[1559] Other LECs argue for 10 percent bands for switched and special,[1560] and SNET proposes 25 percent bands.[1561] Pactel proposes that this Commission waive bands in cases that would otherwise interfere with previous Commission decisions, such as the decision on non-recurring charges.[1562] Lincoln proposes that bands should not apply to rates with revenue weights of less than a certain amount,

---

1555 Ameritech Comments at 25-26, 29; SWB Comments at 26; SNET Reply at 13 n.48 (apply to Part 69 access elements); USTA Reply at 26. See also CCIA Comments at 10.

1556 Ameritech Comments at 30-32; Bell Atlantic Comments at 14; NYNEX Comments at 17, 20-21; Pactel Comments at 47-49; SWB Comments at 22-24; GTOC Comments at 41 (LECs have no incentive to predate because primary competitors are customers); PRTC Comments at 22; SNET Comments at 20-21; USTA Comments at 35; BellSouth Reply at 55-56. See also Rochester Comments at 16-17 (objecting to "no credit zone," but not to stricter tariff review for below-band rates).

1557 Ameritech Comments at 30; BellSouth Comments at 48-49; NYNEX Comments at 17.

1558 NYNEX Comments at 18-19; Pactel Comments at 50-51; Rochester Comments at 15. NYNEX also contends that in order to comply with previous Commission decisions, it must increase LS1 premium rates by 6 percent per year. NYNEX Comments at 19-20.

1559 Ameritech Comments at 30; BellSouth Comments at 48-49; NYNEX Comments at 17 (10 percent upper band should apply to NRCs as well).

1560 US West Comments at 68; Centel Comments at 7; GTOC Comments at 40; Bell Atlantic Reply at 24 n.53; Rochester Reply at 17.

1561 SNET Comments at 13 n.48.

1562 Pactel Comments at 50-51.

and CBT argues for bands that vary inversely with the amount of revenue generated by each service.[1563]

749. API and Ad Hoc agree with the LECs that a floor is unnecessary, and that increased downward pricing flexibility should be permitted the LECs.[1564] Ad Hoc, CCIA, and API suggest that predatory pricing is unlikely, because of the absence of sufficient viable competition, but ALC argues that predation is a likely possibility.[1565] Parties argue, however, that the proposed 5 percent upper band would permit prices to deviate from costs, and allow rate structure changes.[1566] Parties also contend that the bands would permit LECs to manipulate their prices to favor certain customers.[1567] Ohio PUC supports 5 percent bands, but argues that broader bands would provide opportunities to cross-subsidize.[1568] Ad Hoc contends that the 5 percent bands proposed are not sufficiently restrictive to prevent cross-subsidization, rate churn, or strategic pricing.[1569] AT&T disagrees, arguing that a 5 percent upper band will mitigate the possibility of strategic pricing, and that a no credit zone will prevent significant rate restructuring that is not cost-based.[1570]

750. ICA argues that 5 percent upper bands would permit rate changes in excess of historical rate changes in the special access category, and offers a study that purports to support that contention.[1571] LECs disagree with ICA's conclusions, arguing that the study uses limited data, and that only one

---

1563 Lincoln Comments at 7-8; CBT Comments at 6.

1564 API Comments at 25; Ad Hoc Comments at 40.

1565 Ad Hoc (ETI Report at 11); CCIA Comments at 10; API Comments at 25; ALC Comments at 9-10.

1566 See IDCMA Comments at 48; TCA Comments at 10; DC PSC Comments at 17-18; CFA Comments at 23; Colorado OCC Comments at 15; Florida Citizens' Reply at 7. See also EDS Comments at 10; Networks Comments at 19; Michigan PSC Comments at 4; CFA Reply at 6 (5 percent band permits substantial price increases over time).

1567 Comptel Comments at 19-20; AT&T Comments at 37-38; Indiana UCC Comments at 24-25.

1568 Ohio PUC Comments at 12; Ohio PUC Reply at 8.

1569 Ad Hoc Reply at 9.

1570 AT&T Comments at 88 n.****.

1571 See ICA Comments at 25, ETI Report at 41, App. C.

quarter of the changes fall within the range that ICA proposes.[1572] Ad Hoc and ICA propose bands of +1/-10 for switched, and +2/-10 for special.[1573] The Networks propose bands of +2/-5, with a cumulative upper band of 4 percent.[1574] Indiana UCC argues that this Commission should require that all increases be across the board.[1575]

iii. Discussion

751. The Further Notice proposed two baskets: switched access and all other. We now tentatively conclude that it would be preferable to subdivide the switched basket into two baskets corresponding to current Part 69 categories: common line and traffic sensitive switched. Thus, we tentatively decide that LEC services should be placed in three baskets: common line, traffic sensitive switched, and all other. In addition, we tentatively conclude that, for the reasons given above in the AT&T section, the public interest is better served by bands at the service category rather than the rate element level.

752. We tentatively decide that a separate common line basket would ease administration of price cap regulation for the LECs. As we have discussed in the LEC productivity section of this item, because the carrier common line charge is a residual charge affected by revenues from the subscriber line charge and the private line surcharge, the PCI for common line must be calculated differently from the PCIs for the other baskets. Certain exogenous changes, such as changes in Long Term Support for the carriers remaining in the NECA pool, will affect only common line, and it appears desirable to ensure that these exogenous changes are reflected directly in carrier common line (CCL) rates. In addition, a separate common line basket will assist NECA in calculating a theoretical nationwide average CCL rate to be used in determining Long Term Support for LECs remaining in the NECA common line pool.[1576] Therefore, we tentatively decide that common line should be in a separate basket. Because this basket contains only one element that can fluctuate in price, bands are unnecessary.[1577]

1572 Ameritech Reply at 44-45; BellSouth Reply at 52-53; Pactel Reply at 54.

1573 Ad Hoc Comments at 41; ICA Comments at 25.

1574 Networks Comments at 24-25.

1575 Indiana UCC Comments at 25.

1576 See NTCA Comments at 14.

1577 Carrier flexibility in setting rates for the originating and terminating CCL charges, subscriber line charges, and the private line

753. We adhere to our proposal to separate traffic sensitive switched and special access into two baskets. LECs generally favor the combination of traffic sensitive switched and special access services into one basket. Special access customers, on the other hand, support a greater degree of disaggregation of special access services than was proposed in the Further Notice. We tentatively conclude that our proposal to separate traffic sensitive switched and special access into two baskets strikes the correct balance between the concerns raised by users and those raised by carriers. As we stated in the Further Notice, this division appears to us to provide LECs with sufficient flexibility to develop service innovations and achieve efficiencies, while ensuring that ratepayers are protected.[1578]

754. The second basket will contain traffic sensitive switched services, banded by access element.[1579] The most recent round of pleadings has not convinced us of the merits of merging traffic sensitive switched with special access. The LECs may be correct in their assertion that a single basket is the most economically efficient solution. However, economic efficiency is but

---

surcharge continue to be limited by our Part 69 rules. We require LECs, as of April 1, 1989, to set their originating rates at one cent, and their terminating rates to recover the remaining interstate revenue requirement. See Section 69.105 of this Commission's Rules, 47 C.F.R. § 69.105; MTS and WATS Market Structure, Amendment of Part 69 of the Commission's Rules, CC Docket Nos. 78-72, 80-286, Report and Order, FCC 88-399, released Dec. 12, 1988. Nothing in our price cap proposal will enable carriers to raise the subscriber line charge, private line surcharge, or the one cent originating charge, above the levels authorized by this Commission.

1578 See 3 FCC Rcd at 3354-55 (para. 282).

1579 For those carriers that employ the optional Equal Access element in their access tariffs, we tentatively find that the Equal Access element should be considered part of the second basket. We seek comment on this tentative conclusion, and on whether the Equal Access element should be considered as a separate service category subject to the 5 percent upper and lower bands, or as part of the local switching category. See Amendment of Part 69 of the Commission's Rules for the Recovery of Equal Access Costs, CC Docket No. 78-72, FCC 89-16, released Feb. 17, 1989. We also seek comment on applying 5 percent banding limitations to any Basic Service Element (BSE) subelements that may be required to be unbundled under our ONA policies, or other subelements, such as 800 database access, that LECs are required or permitted to offer on an unbundled basis. See Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket No. 89-79, adopted March 30, 1989; Provision of Access for 800 Service, CC Docket No. 86-10, FCC 89-106, adopted March 30, 1989.

one of this Commission's concerns. We also seek to protect ratepayers from disruptive rate or rate structure changes. We recognize that the baskets we propose may leave the LECs with less flexibility than that permitted AT&T, but we tentatively conclude that the lesser degree of competition for LEC switched services creates a correspondingly greater need for regulatory control over pricing flexibility. In addition, we tentatively decide to impose upper and lower bands of 5 percent on the established Part 69 elements: local switching, transport, and information.[1580]

755. The third and final basket will consist of all other services. In the Further Notice, we sought comment on the desirability of further disaggregation of the basket containing special access services. We now tentatively conclude that a third basket containing all special access services, banded by service category, will address the concerns of special access customers while preserving the flexibility necessary to efficient pricing. Special access services are generally purchased by large users, and are the services for which LECs face the most competition. As we have previously discussed in the context of the AT&T plan, either bands or additional baskets can provide supplemental protection to customers.[1581] We tentatively conclude that the banding requirements discussed below will address the concerns of those commenters seeking additional baskets, without imposing the inflexibility that accompanies the creation of additional baskets.

1580 See Sections 69.106, 69.109, and 69.111 of this Commission's Rules, 47 C.F.R. §§ 69.106, 69.109, 69.111. Thus, LEC-provided operator and directory assistance, which Part 69 includes in the the information element, would be included in the second basket. Also included in the traffic sensitive basket is 800 "NXX" access, which is identified as a switching subelement under Part 69. We need not address concerns raised by LECs regarding 5 percent bands on non-recurring charges and LS1 rates since our proposal would not require banding these rate elements.

1581 See Section III.C.2.b, supra.

756. The third basket will be dominated by special access, but will also contain corridor interstate services.[1582] We tentatively conclude that 5 percent upper and lower bands at the service category level are suitable for

---

1582 Hawaii has also generally raised the issue of how to treat GTOC's provision of IMTS and international private line services to and from the State of Hawaii under a price cap system of regulation. See generally Hawaii Comments at 20-23. Like AT&T in its provision of IMTS, GTOC is treated by this Commission as a dominant carrier of IMTS. Our decision to implement price caps for AT&T first means that, at least for a limited period of time, GTOC's Hawaiian affiliate will be offering IMTS under rate of return, while AT&T will be offering competing services under a price cap system. The alternative, to permit GTOC to implement price caps for IMTS at the same time as AT&T (on July 1, 1989), raises issues that are beyond the scope of the existing record. For example, the baskets and bands assigned for AT&T are based on national services offered by the largest provider of interexchange services. We have not examined if GTOC's provision of IMTS under price caps warrants a separate basket for IMTS or if IMTS should be included in the third, "all other" basket we are proposing for LECs.

To remedy the absence of information concerning this subject, we seek comment on price cap treatment of GTOC's provision of IMTS from Hawaii. We propose to include GTOC's IMTS in the third LEC basket, and to treat IMTS as a separate service category subject to 5 percent upper and lower bands. We do not believe that, given the emerging competition for GTOC's IMTS offering, that placing IMTS in its own basket is necessary. Such an approach would sharply limit GTOC's pricing flexibility, a result that we believe is not warranted. We will not, as part of this proceeding, consider whether GTOC remains dominant in its provision of IMTS. In the event GTOC were declared non-dominant, it would become subject to the tariff regulations applicable to other non-dominant interexchange carriers. GTOC's provision of international private line service to and from Hawaii need not be considered under price cap regulation, because this Commission declared non-IMTS international services to be non-dominant in 1985. International Competitive Carrier Policies, 102 FCC 2d 812 (1985), aff'd on recon. 60 RR 2d 1435 (1986), recon. denied FCC 86-339 (1986).

special access. Service categories would track existing services, e.g., (1) metallic; (2) telegraph; (3) program audio; (4) voice grade; (5) video; (6) wideband audio; (7) wideband data; (8) digital data; (9) high capacity; and (10) for those LECs that offer it, interexchange or corridor service.[1583] We tentatively conclude that new services, or services not on this list, should be classified at the same level of generality. Under this proposal, the service banding index for each service category could not increase or decrease by more than 5 percent per year after adjusting for the PCI.

757. We propose to apply banding limitations to service categories, instead of limiting prices of individual rate elements. In the case of the traffic sensitive basket, bands would apply to the access elements we identify: local switching, transport, and information. In the case of the "all other" basket, bands would apply to the service categories enumerated, above. We tentatively conclude that use of these categories, instead of individual rate elements, satisfies our concern that pricing flexibility granted to carriers under a price cap system is balanced by the need to avoid rate shock.

758. Like the AT&T price cap plan we adopt, the proposed price cap plan for LECs includes 5 percent upward and downward limits on LEC service prices each year. Should a LEC file a tariff that results in a service being priced outside the 5 percent bands, as measured by a service band index we discuss below, the tariff must be filed on a longer notice period and be accompanied

---

1583 See, e.g., Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase I, Memorandum Opinion and Order, FCC 86-52,released Jan. 24, 1986 at para. 6; Investigation of Access and Divestiture Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part I, Memorandum Opinion and Order, Mimeo No. 2647, released Feb. 19, 1985 at para. 25.

by additional support materials.[1584] While we have tentatively found that LECs are subject to far less competition than is AT&T, the emergence of competition for LEC services appears to require the same kinds of safeguards that we decided were necessary to act as a check on AT&T's ability to set prices in an anticompetitive manner. The upper banding limit of 5 percent appears necessary to protect against rate shock. We seek comment on our tentative conclusion that lower bands and upper bands are necessary for the LEC traffic sensitive and "all other" basket. We also seek comment on whether those bands should be set at the same level as AT&T's bands. In addition, we decline to adopt the tentative conclusion, reached in the Further Notice, that the LECs should not receive credit for any price decreases below 5 percent for the purpose of establishing compliance with the PCI. As in the case of AT&T, we believe that if a LEC can justify a below-band filing, it ought to receive full credit for the price decrease.

759. This Commission has also recently adopted guidelines to address a slightly different rate relationship issue, strategic pricing.[1585] The strategic pricing guidelines were adopted in the context of rate of return regulation. We seek comment on the continued applicability of these guidelines in a price cap system. Parties arguing for the continued application of the guidelines should discuss any modifications that would be necessary to adapt the guidelines for use with price cap regulation.

3. Comparing LEC Rates to the PCI and Banding Limitations

a. Operation of the Actual Price Index for LECs

i. Summary of Further Notice

760. As we discussed in Section III.C.3.a.i, supra, the Further Notice proposed to measure carrier rate levels through the use of an Actual Price Index (API) and a Base Price Index (BPI). These indexes operated to compare proposed rates to base period average rates. We proposed to use identical indexes for both AT&T and the LECs.

1584 See Section IV.C.5, infra. Bands do not apply to the common line basket, since we are granting no pricing flexibility for end user charges.

1585 Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase II, Part 1, Memorandum Opinion and Order, FCC 88-321, released Dec. 1, 1988, recon. pending.

ii. Pleadings

761. The parties' comments regarding the proposed API and BPI formulas do not distinguish between AT&T and the LECs.[1586] As discussed in connection with the AT&T plan, most parties commenting on the issue raise concerns regarding the comparison of proposed rates to average rates, and urge this Commission to modify the formulas to compare point-in-time rates instead.

iii. Discussion

762. We tentatively find the issues regarding the mechanics of measuring LEC rates to be indistinguishable from those discussed in connection with AT&T. Thus, we propose to modify the API and BPI formulas proposed in the Further Notice to mirror the point-in-time API we are adopting in the AT&T plan. In particular, we propose that rate changes in each LEC basket be measured according to the following formula, the terms of which are defined in Section III.C.3.a.iii, supra:

$$API_t = API_{t-1}[\Sigma_i \, v_i(p_t/p_{t-1})_i].$$

b. Special Case Rules Regarding API Calculations

i. Summary of Further Notice

763. In the Further Notice, we proposed special rules for incorporating new services into the API for the affected basket.[1587] We also tentatively concluded that service restructuring and service abandonment would require that the affected API be recalculated using estimation techniques that would not be necessary in measuring simple rate level changes.[1588]

ii. Discussion

764. As we noted in connection with the AT&T plan, commenters have not directly addressed the mechanics of the special case rules proposed in the Further Notice.[1589] We believe, however, that the API measurement approaches we adopted for AT&T in connection with new, restructured, and abandoned

---

1586 See Section III.C.3.a.ii, supra.

1587 See Further Notice, 3 FCC Rcd at 3442 (paras. 462-63); see also Section III.C.3.b.i, supra.

1588 See Further Notice, 3 FCC Rcd at 3441, 3442 (paras. 461, 464); see also Section III.C.3.b.i, supra.

1589 See Section III.C.3.b.ii, supra.

services apply equally to our proposed LEC plan. We therefore propose to treat LEC API calculations in connection with such service adjustments in the same manner described in Section III.C.3.b.ii, supra. In particular, we propose that new LEC services be incorporated into the proper APIs at the first annual price cap filing following completion of the base period in which they are introduced, using weights established during the base period. We also propose that LECs immediately adjust their APIs to reflect service restructuring or abandonment, using estimation techniques to assign customers of the abandoned or restructured services to those remaining or becoming available following the change.

c. Operation of the LEC Service Band Index

i. Summary of Further Notice

765. As with AT&T, we proposed in the Further Notice to supplement the PCI's limitations on aggregate LEC rate levels with rate element bands.[1590] Thus, we tentatively concluded that in order to receive streamlined tariff review treatment, a proposed tariff revision must not only satisfy the aggregate cap, but that the proposed price for each rate element must fall within a 10 percent zone, with the midpoint being the rate element price in effect on the last day of the base period, adjusted by the percentage change in the PCI.[1591] We also proposed to ignore rate reductions below the lower band limits in calculating the affected API, thereby limiting the carrier's power to increase other rates in the basket without exceeding the aggregate rate ceiling imposed by the PCI.[1592]

ii. Discussion

766. As discussed in Section IV.C.2.b, supra, we have tentatively concluded that it would best serve the public interest to band LEC rates by service category, rather than by rate element.[1593] In order to implement service bands, we propose that LECs establish for each service category subject to banding a Service Band Index (SBI) identical in design to the SBI mechanism we are adopting for AT&T. Thus, we propose that changes in service

---

1590 Further Notice, 3 FCC Rcd at 3440 (para. 455).

1591 Id. at 3440 (paras. 456-57). See also Section III.C.3.c.i, supra.

1592 Further Notice, 3 FCC Rcd at 3441 (para. 458).

1593 In Section IV.C.2.b, supra, we stated that the service categories for the traffic sensitive basket would coincide with the Part 69 elements: local switching, transport, and information.

category rates be measured according to the following formula, the terms of which are defined in Section III.C.3.c.ii, supra:

$$SBI_t = SBI_{t-1}[\Sigma_i \, v_i(p_t/p_{t-1})_i].$$

We propose that in order to receive streamlined filing and review treatment for a tariff revision, the value of each affected SBI may not increase or decrease by more than 5 percent, relative to the percentage change in the PCI, measured from the the last day of the previous tariff year.

4. Establishing Initial Index Values

a. Use of LEC Existing Rates

i. Summary of Further Notice

767. In the Further Notice, we tentatively determined that we should utilize existing rates as the point of departure in establishing initial price and cost index levels.[1594] We explained that such rates have already survived, at a minimum, the tariff review process under current rate of return procedures, and thus carry with them sufficient indicia of reasonableness for the limited purposes they will serve in initiating price cap regulation.[1595] In making this tentative assessment, we determined it was not feasible to adopt a general standard, such as stand-alone or incremental cost, for establishing initial price cap rates.[1596] We also tentatively concluded that a full scale rate investigation of LEC rates would unnecessarily delay price cap regulation and would likely be unproductive.[1597] Nevertheless, we sought comment on a proposal to apply an initial downward rate adjustment factor to existing LEC rates.[1598]

ii. Pleadings

768. All commenting LECs and two states agree in principle with this Commission's tentative conclusion that existing LEC rates offer the most

---

1594 Further Notice, 3 FCC Rcd at 3331 (para. 250). For a more detailed summary of the Further Notice, see Section III.C.3.d.i.(1), supra.

1595 Id. at 3333-35 (paras. 252, 254).

1596 Id. at 3338-39 (para. 262).

1597 Id. at 3332 (para. 251).

1598 Id. at 3337-38 (para. 259).

reasonable point of departure for initiating a LEC price cap plan.[1599] Although their proposals vary in detail,[1600] these commenters generally assert that since existing rates have survived current tariff review procedures, and in some cases investigations, they provide adequate assurance that each LEC's PCIs and APIs would begin at reasonable levels for the purpose of establishing the no-suspension zones contemplated in the Further Notice.[1601] They note that any rate changes required as a result of pending

---

1599 See, e.g., Ameritech Reply at 48; Bell Atlantic Comments at 9; BellSouth Reply at 8; CBT Comments at 5; Centel Reply at 9; Contel Reply at 13-16; GTOC Comments at 10-11, 22-23; Lincoln Comments at 4; NYNEX Comments at 41; Pactel Comments at 25; Rochester Comments at 8-9; SNET Comments at 22-23; SWB Comments at 12; United Comments at 9; USTA Reply at 22; US West Comments at 42-45; Illinois Comments at 24; Ohio PUC Comments at 10-11. See also Section III.C.3.d.i.(2), supra; many of the comments with regard to use of existing rates in the AT&T price cap plan do not distinguish between AT&T and the LECs on this issue.

1600 Most LECs propose that this Commission eliminate rate and cost data from 1987 in establishing initial PCI and API levels due to significant cost changes beginning in 1988 resulting from several regulatory changes, including revisions to this Commission's separations and accounting rules. See, e.g., Ameritech Comments at 11-13; Bell Atlantic Comments at 10 n.20; Centel Comments at 10; Contel Reply at 13-16; GTOC Comments at 22-23. Cf. SNET Comments at 22-23 (proposing use of average rates in effect during complete calendar years 1987 and 1988). Thus, carriers variously propose that we initiate price caps based upon rates in effect on the last day of the proposed pre-price cap base period (e.g., CBT Comments at 5; Contel Reply at 13-16; USTA Comments at 36-38), or rates in effect the day before price caps begin (e.g., Bell Atlantic Reply at 21; US West Comments at 42-45). Several carriers propose, or would accept, retargeting of rates existing on the selected benchmark date to the authorized rate of return. See, e.g., Ameritech Comments at 14; NYNEX Comments at 40-42; Pactel Reply at 5, 36-37. But see Comptel Reply at 15-16; ICA Reply at 2; Networks Reply at 5-6 (all opposing retargeting as a means of allowing carriers to inflate further their stated costs). Rochester proposes that we permit LECs to increase non-recurring charges to levels that fully recover their costs prior to implementation of price caps. Rochester Comments at 15-16. Ohio PUC urges this Commission to make every attempt to resolve pending investigations and complaints regarding existing rates prior to beginning price caps. Ohio PUC Comments at 11.

1601 E.g., SWB Comments at 12-13; NYNEX Comments at 41; Pactel Reply at 4-5; SNET Reply at 17.

investigations can be implemented through adjustments to price cap levels after the new regulatory program is underway.[1602]

769. Numerous other commenters express varying degrees of concern regarding existing LEC rate levels. These parties contend generally that the LECs' prescribed rate of return is too high given current market conditions,[1603] that current rates are yielding carriers returns in excess of prescribed levels,[1604] or that existing rates reflect inflated costs.[1605] A number of users of LEC interstate services complain that current rates for specified services are excessive, or otherwise are not cost-based.[1606] Several parties are particularly critical of LEC special access rates, such as those for High Capacity (HiCap) Services.[1607] The Networks claim television service rates are excessive.[1608] Hawaii argues that GTE Hawaiian Telephone Company's IMTS rates are excessive.[1609]

770. As a result of these concerns regarding existing LEC rates, a number of commenters assert that prior to implementing price caps this Commission must conduct comprehensive rate investigations to ensure that all

---

1602 E.g., Ameritech Reply at 48; CBT Reply at 13-14; Pactel Reply at 4-5; USTA Reply at 23.

1603 E.g., Florida's Citizens Reply at 5-6; CFA Reply at 5-6; ICA Comments at 13-14; MCI Comments at 7.

1604 Cable & Wireless Reply at 3; Florida's Citizens Reply at 5-6; ICA Comments at 13-14; MCI Comments at 7.

1605 E.g., Florida's Citizens Reply at 5-6; Connecticut Comments at 9-10; ICA Comments at 13-14; MCI Comments at at 7, 41; NARUC Reply, App. C; SBA Comments at 9-10.

1606 E.g., API Comments at 22-24; Arinc Comments at 2-3; ICA Comments at 13-14; IDCMA Comments at 42; MCI Reply at 10; Networks Comments at 7-10; TCA Reply at 11-12.

1607 E.g., Arinc Comments at 2-3; Cable & Wireless Reply at 4; ICA Comments at 14; IDCMA Comments at 44; MCI Comments at 22-24.

1608 Networks Comments at 7-10.

1609 Hawaii Comments at 20-23; Hawaii Reply at 8-9. The GTOCs strongly dispute this contention. See GTOC Reply at 27-29.

rates are just, reasonable, and nondiscriminatory at the outset.[1610] Other parties assert that we should investigate rates at the basket level to ensure that the aggregate return does not exceed the prescribed level, but that we need not resolve individual rate design issues prior to implementing price caps.[1611] The Networks propose that initial price cap tariffs be subject to current tariff review procedures, and that those proposed rates which are challenged without resolution prior to the effective date of the initial price cap tariffs should be suspended, set for investigation, and made subject to accounting orders.[1612]

771. Several parties support our alternative proposal to lower LEC rates at the outset of price cap regulation in order to "squeeze out" inefficiencies that are allegedly embedded in existing rate levels.[1613] However, one state and all commenting LECs strongly oppose such up front cuts, arguing that there has been no demonstration of cost padding, and that such cuts would require the LECs to pass through to ratepayers efficiency gains that have not yet been achieved.[1614]

iii. Discussion

772. As we decided with respect to AT&T,[1615] we tentatively conclude that reliance upon existing rates, developed under established rate of return procedures, is the most reasonable option for initially determining compliance with a price cap system for LECs. We are cognizant that the existing rates of AT&T and the LECs are subject to different levels of competition, and that the greater competition for AT&T's services provides an additional measure of assurance with respect to the reasonableness of existing rates. As we

---

1610 See Ad Hoc Comments at 7-8, 49-53; DC PC Reply at 5; Michigan PSC Comments at 17; New Hampshire PUC Comments at 24-25.

1611 Indiana UCC Comments at 11; TCA Reply at 12-13.

1612 Networks Comments at 15-18.

1613 E.g., Indiana UCC Comments at 11-12; ICA Comments at 16-18; Michigan PSC Comments at 17. See also SBA Comments at 9-10 (suggesting that we evaluate whether individual carriers have embedded inefficiencies by comparing their relative costs, exclusive of loop costs and regionalized cost of living differences).

1614 Illinois Comments at 24; GTOC Comments at 10-11; Lincoln Comments at 4; NYNEX Reply at 15; Pactel Comments at 26; Rochester Comments at 8-9; United Comments at 11.

1615 See Section III.C.3.d.i, supra.

discuss below, we do not believe that the lesser degree of competition faced by LECs renders LEC rates per se unreasonable and in need of adjustment. Therefore, our analysis of the existing rate issue follows generally the reasoning outlined earlier regarding use of AT&T's existing rates.

773. First, we do not believe the conduct of a comprehensive rate case prior to initiating a LEC price cap plan would serve the public interest. Such a proceeding would demand that this Commission employ a cost allocation methodology so that joint and common costs incurred in providing regulated services are accounted for in a systematic way. However, as we noted with respect to AT&T, cost allocation standards do not necessarily bear any direct relationship to economic efficiency.[1616] Given the limited potential utility of such a proceeding and our view that price cap regulation offers ratepayers and carriers significant potential benefits, we do not believe that the indefinite delays that could result from conducting rate cases for each LEC can be justified.[1617]

774. Despite our reluctance to undertake a comprehensive, rate of return style rate case prior to implementing price cap regulation, we believe that some initial across-the-board rate cut for LECs may be desirable, if adequate

---

1616 Id.

1617 Hawaii raises the issue of the level of GTOC's IMTS rates as a suitable starting point for price caps. Hawaii Comments at 20-23. Hawaii contends that the absence of rate integration for Hawaii has created an environment in which GTOC and AT&T charge higher rates for international service to and from Hawaii than AT&T does from the mainland. GTOC, in response, argues that it has been regulated as a dominant carrier by this Commission, and that its rates are not excessive. GTOC also argues that the IMTS market in Hawaii is characterized by new entrants, and that competition will further protect consumers. GTOC Reply at 27-29.

We are not insensitive to the view that IMTS rates are too high. This Commission has been actively reviewing international accounting rates issues in order to prompt renegotiation of such rates to benefit consumers in Hawaii and across the United States. Since this is an ongoing process that requires the participation of foreign administrations, we do not believe it necessary or desirable to postpone price caps until all international accounting rates have been reformed. Furthermore, we tentatively conclude that the presence of competition among IMTS providers to and from Hawaii makes it unlikely that GTOC can offer its services at "excessive" rates, holding aside the issue of accounting rates. In the past few years, four competing long distance carriers have begun to offer IMTS in Hawaii. We tentatively conclude that GTOC's existing IMTS rates, subject as they are to competition, should be sufficient to inaugurate a price cap system.

support for such an adjustment can be developed. We concluded in Section II of this Order that rate of return creates opportunities for carriers to be inefficient in the provision of regulated services. As a result, existing LEC rates are too high in the sense that they reflect decisions made pursuant to a regulatory system that encourages inefficiency. The current record, however, provides an insufficient basis upon which to propose an initial LEC rate adjustment. We seek further comment on this issue. Commenters are encouraged to specify the magnitude of their proposed rate adjustments and the empirical basis for such proposals, as well as any legal issues raised by this alternative proposal.

775. We do not agree with those commenters who suggest that current earnings levels exhibited by some LECs warrant an adjustment to rates before price caps can be implemented. We recognize that some LECs are currently reporting earnings in excess of authorized levels for some services. In a separate proceeding, the Common Carrier Bureau is moving to reduce overearnings to authorized levels.[1618] We also realize that compliance with the rate of return prescription will be particularly important with respect to the rates in effect just prior to the advent of price caps, and we expect that carrier rates at the time price caps are implemented would be carefully targeted to achieve the authorized rate of return. However, since overearnings by LECs are not uniform or consistent across service categories, we tentatively find that the record on carrier earnings does not support a uniform across-the-board rate cut. Parties will continue to be able to challenge LEC rates through the tariff review and complaint processes, and this Commission will continue to examine carrier rates independently through the monitoring and performance review features of the proposed regulatory plan.

776. Finally, while we plan to move expeditiously on current investigations of LEC rates, we tentatively conclude that completion of all pending investigations is not a necessary predicate to the commencement of price caps. As with AT&T, we believe that the results of any investigations that may be pending after the advent of price caps can be dealt with adequately through price cap adjustments, refunds, or both. We note, however, that most commenters questioning the use of existing rates for the LECs have focused on special access tariffs.[1619] In this regard, we have recently

---

1618 The Common Carrier Bureau recently directed certain LECs to file rate reductions to achieve the prescribed rate of return, or to show cause why they should not be required to do so. Local Exchange Carrier Access Tariff Rate Levels, CC Docket No. 88-554, DA 88-1869, Order To Show Cause, released Dec. 2, 1988.

1619 See, e.g., Arinc Comments at 2-3; Cable & Wireless Reply at 4; ICA Comments at 14; IDCMA Comments at 44; MCI Comments at 22-24.

examined the most controversial of these tariffs in our Strategic Pricing Order.[1620] In that Order we have established generic standards for evaluating the reasonableness of special access rates under rate of return regulation and have required that carriers demonstrate that their rates for 1.544 Mbps High Capacity Service (HiCap) and Digital Data Services (DDS) satisfy these guidelines. We are confident that whatever rates result from this investigation and any remedial action we take in connection therewith will provide a reasonable point of departure for establishing a no-suspension zone under price caps.

777. In summary, while we believe price caps will provide strong incentives to improve efficiency, we tentatively conclude that the consumer productivity dividend we have proposed is better targeted to reflect anticipated productivity gains than an initial rate cut would be. We nevertheless would welcome comments on how to accomplish an initial rate cut that would drive out the inefficiencies that have been built into existing rates as a result of rate of return regulation. We tentatively conclude that a rate of return type rate case would not achieve this objective, and would simply delay the benefits of price caps.

b. LEC Start-Up Issues

i. Summary of Further Notice

778. In the Further Notice, we proposed to establish initial PCI and base price index (BPI) values for the LECs in the same manner that we proposed for AT&T.[1621] As described in more detail in Section III.C.3.d.ii, supra, we proposed to establish initial index values of 100 based upon carrier costs and rates in effect during the pre-cap base period from October 1, 1987, through September 30, 1988. We tentatively concluded that in their inaugural price cap filings, LECs should be required to adjust their PCIs and APIs to reflect the difference between the costs and rates for the period covered by the first price cap tariffs and the average costs and rates in effect during the pre-cap base period. We required that the initial APIs not exceed the corresponding PCIs.

ii. Pleadings

779. In general, the parties' comments do not differentiate between AT&T and the LECs with respect to the method proposed in the Further Notice for

---

1620 Investigation of Special Access Tariffs of Local Exchange Carriers (Strategic Pricing Order), CC Docket No. 85-166, Phase II, Part 1, FCC 88-321, released Dec. 1, 1988.

1621 See generally Further Notice, 3 FCC Rcd at 3436-39 (paras. 447-453).

establishing initial index values. As described in Section III.C.3.d.ii.(2), supra, the most prominent criticisms of our proposed start-up procedures relate to the use of a blended average of 1987 and 1988 costs and rates, rather than 1988 data, as points of reference for calculating initial PCI and API levels. Several parties stress that these proposed procedures could result in an inaccurate reflection of the relationship between rates and costs at the outset of price caps.[1622] Thus, a number of these parties propose that we exclude 1987 data from the initial pre-cap base period, and that we establish initial cap levels based upon rates and costs in effect on a date certain.[1623] As noted with respect to the AT&T plan, some commenters also contend that we should modify the inflation and productivity variables (GNP-PI - X) in the initial PCI adjustment to reflect the fact that the initial price cap year proposed in the Further Notice (April 1, 1989, through June 30, 1990) is 15 months, rather than 12 months, long.[1624]

iii. Discussion

780. Our decision to propose LEC API and PCI formulas that, like those we are adopting for AT&T, compare point-in-time prices and costs eliminates the necessity of calculating base period average costs and prices in establishing initial price cap levels. Thus, our analysis of the mechanics of initiating AT&T's indexes applies generally to our LEC proposal as well. In particular, we propose that LECs use calendar year 1989 service demand and cost data to establish initial base period weights, and that they set initial API, SBI, and PCI values at 100, corresponding to the rates and costs in effect on December 31, 1989. Any changes in rates or exogenous costs between that date and the effective date of the first annual LEC price cap tariffs on July 1, 1990, should be reflected in adjustments to those indexes. As with AT&T, since our revised LEC implementation schedule provides for a 12-month, rather than 15-month, initial tariff year, there is no need to make any corrective adjustment to the PCI formula's productivity and inflation variables (GNP-PI -X) in connection with the first annual price cap filing.

1622 Commenting LECs appear particularly concerned about the effect of revisions to this Commission's separations and accounting rules that became effective in 1988. Ameritech Comments at 11-13; Bell Atlantic Comments at 10 n.20; Centel Comments at 10; Contel Reply at 13-16; GTOC Comments at 22-23.

1623 See, e.g., Bell Atlantic Comments at 10 n.20; USTA Reply at 22-23 (proposing that initial PCI and API levels should be calculated using rates and costs in effect on the last day of the pre-cap base period as the benchmark); AT&T Comments at 36; Ameritech Comments at 11-14 (proposing that this Commission initialize the APIs and PCIs based upon price and costs in effect the day before price cap regulation becomes effective).

1624 GTOC Comments at 39; SWB Comments at 15-16; Pactel Comments at 41-43.

5. Evaluation of Price Cap Rates

781. The price cap plan presented in the Further Notice was designed to distinguish those tariff filings to which we could reasonably apply streamlined review procedures from those requiring closer scrutiny. For purposes of tariff review, the plan first divided services into two discrete categories: (1) filings for services not subject to price cap regulation and (2) filings for services subject to such regulation. The former would continue to be subject to traditional tariff filing requirements and standards of review. For price cap services we proposed to require an annual price cap filing, in addition to routine filings to change rate levels.

782. We grouped tariff filings for services covered by price cap regulation into six subcategories: (1) within-band filings; (2) above-band filings; (3) below-band filings; (4) above-cap filings; (5) filings for new services; and (6) filings proposing to restructure a service already within a basket. We proposed a different combination of filing requirements and review standards for each of the six kinds of filings. We now reexamine the procedural rules proposed in the Further Notice in light of the record developed in response to that Notice and the changes to the baskets, bands, and price cap index components that we are proposing in this Second Notice.

a. Annual filing

i. Summary of Further Notice

783. The Further Notice proposed that the LECs file their first annual price cap tariff on December 30, 1988, with an effective date of April 1, 1989.[1625] Recognizing a need to adjust the price cap index on a periodic basis to reflect changes in the carriers' costs of operation, we proposed that in 1990 and thereafter, the LECs file their annual price cap tariffs on 90 days' notice and with an effective date of July 1.[1626]

ii. Pleadings

784. Few parties address the need for, or the proposed contents of, the LEC annual price cap filing. Centel suggests that each filing should include a comparison of the proposed rates with the then-existing rates.[1627]

1625 Further Notice, 3 FCC Rcd at 3368 (para. 304).

1626 Id. (para. 306).

1627 Centel Comments at 4. We note that the formulas we are now proposing, which differ from those proposed in the Further Notice, will result in filings that provide the comparative information suggested by Centel.

iii. Discussion

785. We now propose that the first annual price cap tariff filing, in which LECs calculate price cap indexes and actual price indexes for each of the service baskets covered by the plan, should become effective on July 1, 1990. Under this timetable, the LECs would make their annual filings on March 30, 1990, with an effective date of July 1. We tentatively conclude that such filings should comply with the requirements for annual price cap filings we have adopted for AT&T.[1628]

b. Within-band rate level changes

i. Summary of Further Notice

786. The Further Notice called for streamlined treatment of both AT&T and LEC filings that proposed changes in rate levels, so long as the proposed change in service rates produced an API for the basket to which the service was assigned that was no greater than the PCI and the new rates satisfied the rate band limitations. Streamlined filings would be made on 14 days' notice and would be presumed lawful. They would be supported by calculations demonstrating that the proposed rates did comply with the price cap and rate bands.

787. We proposed that presumptively lawful tariffs would not be suspended unless the party seeking suspension could show (1) a high probability that the tariff would be found unlawful; (2) that suspension would not substantially harm other interested parties; (3) that irreparable injury would result if suspension did not issue; and (4) that suspension would not otherwise be contrary to the public interest.[1629] We tentatively found that use of this test to establish a "no-suspension zone" was warranted because within-band rates could be presumed, for tariff review purposes, to fall within the zone of reasonableness.

ii. Pleadings

788. Most of the arguments raised in opposition to streamlined treatment for within-band filings did not distinguish between the LECs and AT&T. Some

---

1628 See Section III.C.4.a, supra.

1629 This four-part test is similar to that used by courts ruling on requests for preliminary injunction, see, e.g., Virginia Petroleum Jobbers Ass'n. v. FPC, 259 F.2d 921 (D.C. Cir. 1958).

users, competitors, and state regulators view the proposal as unfairly assymetrical in its distribution of risks and burdens between carriers and petitioners.[1630] They state particular concerns that the unavailability of cost data to petitioners will prevent petitioners from ever satisfying the required showing for suspension.[1631] Maryland PC argues that the proposal violates the Act by improperly shifting the burden of proof in proceedings under Section 204(a);[1632] its position is strenuously opposed by several carriers.[1633] All of these arguments are set forth in more detail in Section III, supra.

iii. Discussion

789. We conclude in Section III that our proposal does not illegally shift to petitioners the burden of proof which Section 204(a) assigns to carriers in hearings on proposed rate increases. We emphasize that the presumption of lawfulness that attaches to within-band rates does not survive if the tariff is set for investigation. We now tentatively find that this conclusion is equally valid for the streamlined procedures we propose to apply to within-band tariff filings for LECs. We seek comment on this tentative finding.

790. We also reject in Section III arguments that the procedural rules we had proposed would create asymmetrical burdens of proof on petitioners seeking suspension of a within-band filing and carriers seeking to file above-cap rates.[1634] Those making this claim did not distinguish between AT&T and the LECs. Our rationale for rejecting their claims with respect to AT&T turns, in part, on our conclusion that "the separate burdens on ratepayers and on carriers should each be commensurate with the risk to each group that a within-cap rate will be unreasonable."[1635] We find it extremely unlikely, although not impossible, that rates based on existing AT&T rates, as constrained by the price cap formula defined for AT&T and as further constrained by competitive forces, would be unreasonably high.

1630 See, e.g., Ad Hoc Comments at 14-15.

1631 ALC Comments at 10; API Comments at 26-27; ICA Comments, Att. B at 77; NARUC Reply at 14-15.

1632 Maryland PC Comments at 18-19.

1633 SWB Reply at 39-40; GTOC Reply at 12-14.

1634 See id.

1635 Id.

791. For many of the same reasons as given for AT&T, we tentatively conclude that it would be extremely unlikely that rates based on then-existing LEC rates, as constrained by our proposed LEC price caps mechanism, could be unreasonably high. As we have explained above, that mechanism would include an additional backstop, either an automatic stabilizer or an earlier comprehensive performance review. For these reasons we tentatively conclude that it is reasonable to attach a presumption of lawfulness to LEC tariff filings proposing rate changes that meet the price cap indexes defined by our LEC price cap formula and banding limitations. We also tentatively conclude that it is reasonable and consistent with our obligations under the Communications Act to treat such filings under the rules we have already adopted to govern AT&T's tariff filings satisfying this condition. We seek comment on the validity of these tentative conclusions.

792. For AT&T, we have rejected the request of some commenting parties that we eliminate the requirement of a "showing of irreparable harm," in part on our assumption that while a large customer might be unable to make a credible argument that a rate increase would irreparably harm it, competition would likely shield that customer from such unjustified rate increases.[1010] We seek comment on whether any competitive differences in LEC markets require that we modify the showing that a petitioner must make to justify suspension of a LEC's within-band tariff filing, or whether other differences proposed in the LEC price cap structure make such a change unnecessary or undesirable. We reiterate that we do not expect petitioners to do the impossible, producing cost data to which they would not have access at the time they file their petitions to suspend. In Section III, we list several examples of the sort of evidence that should lie within a potential petitioner's grasp and that could be sufficiently persuasive to support a requirement that the carrier provide additional rate information.[1637] We also reiterate that under our price cap proposal a showing insufficient to justify suspension of a within-band filing might still be adequate to persuade us that an investigation of that filing was warranted and could serve as the basis of a Section 208 complaint process.

c. Above-band rates

i. Summary of Further Notice

793. In the Further Notice we tentatively concluded that we would require 90 days' notice for any tariff filing which proposed to raise rates above the 5 percent price band, even if the filing did not push the actual

---

1636 Id.

1637 Id.

price index above the price cap index.[1638] We concluded that such tariffs would face a high probability of suspension and that, to become effective, they would have to be supported by a showing of substantial cause.[1639]

ii. Pleadings

794. To the extent that comments filed in response to the Further Notice address the issues of filing requirements and the standard for review applicable to above-band rate proposals, they do not focus on the question whether differences between the LECs and AT&T or the markets they serve require that the procedures governing LEC above-band filings differ from those applied to AT&T. Some carriers find the 90 days' notice requirement to be excessive.[1640] Michigan PSC, on the other hand, contends that notice periods as long as a year might be needed to allow proper analysis of above band proposals.[1641] Several parties urge particular interpretations of the substantial cause test.[1642] Some oppose use of that standard either because it is vague and ill-defined[1643] or because it is too narrowly limited by the facts of the RCA American Communications cases to be used as we have proposed.[1644] We summarize these pleadings in more detail in Section III, supra.

ii. Discussion

795. In Section III, we find that 90 days' notice is necessary to allow us to determine the reasonableness of AT&T's above-band filings; we now

---

1638 Further Notice, 3 FCC Rcd at 3374 (para. 316).

1639 Id. at 3373 (para 314). In RCA American Communications, Inc., 86 FCC 2d 1197 (1981), we set forth, described, and applied the standard for tariff review that we call the substantial cause test. In Section III, we have clarified how we would apply such a test in a price cap regime. See Section III.C.4.c.

1640 CBT Reply at 24-25; AT&T Comments at 28-30.

1641 Michigan PSC Comments at 21-22. As noted previously, 90 days is the maximum notice period allowed by the Communications Act.

1642 See NTN Comments at 21-22; TCA Comments at 10; TCA Reply at 20.

1643 See DC PSC Comments at 17; MCI Reply at 25-26; NARUC Reply at 13-14.

1644 See Cable & Wireless Comments at 32; Comptel Comments at 26-27; United Comments at 14.

tentatively make that same finding with respect to the LECs. We also examine the arguments of the parties who challenge our use of the substantial cause standard in reviewing above-band rates filed by AT&T and conclude that that standard is neither too ill-defined nor too narrowly defined for its proposed use. Because we tentatively find that the reasoning underlying that conclusion applies with equal validity to the case of a LEC filing above-band rates, we apply that reasoning here and tentatively reach the same conclusion.

796. In Section III, we identify fairness to customers as an essential component of the substantial cause test. We now tentatively find that, like the plan we have adopted for AT&T, the price cap plan we propose for the LECs creates in ratepayers the reasonable expectation that no individual rate will rise more than a fixed amount each year. We tentatively find that the substantial cause test can protect both that expectation of rate stability and the substantive and procedural rights of carriers. We further tentatively find, as we did with respect to AT&T, that when cost increases form the heart of a substantial cause showing, our investigation of that showing should ordinarily focus on the reasons why the carrier is applying the cost increase to a particular service or individual rate elements.[1645] Accordingly, we tentatively decide to impose the same filing requirements and standard of review upon above-band filings by LECs that we have adopted for AT&T. We seek comment on whether there are any factors distinguishing the LECs from AT&T that would warrant our revising either the filing requirements or the standard of review applied to their above-band filings.

d. Above-cap rates

i. Summary of Further Notice

797. In the Further Notice we proposed that any tariff proposing above-cap rates would be filed on 90 days' notice and would generally be suspended.[1646] We proposed to require carriers to support such filings with cost data for each element in the relevant basket for each of the most recent four years under price cap regulation, along with a comprehensive explanation of how the carrier had allocated costs among rate elements in that basket.[1647] We tentatively concluded that this extensive showing was necessary to insure

---

1645 Thus, as explained more fully in Section III, neither individual customer reliance on rates, nor the unforeseeability of cost increases, are crucial elements of the substantial cause test as it will apply to LEC interstate rates under price caps.

1646 Further Notice, 3 FCC Rcd at 3374 (para. 316).

1647 Id. at 3375 (para. 319).

that costs driving prices above the cap were prudently incurred and that the proposed increases were just and reasonable.

ii. Pleadings

798. Some carriers argue that the proposed cost showing is excessive and unreasonable.[1648] Ameritech proposes that above-cap filings be supported by total interstate cost and revenue data and that such rates be allowed if justified by extraordinary circumstances.[1649] Ad Hoc, on the other hand, views the proposal as no more stringent than the cost support requirement currently applicable to routine tariff filings. According to Ad Hoc, we should more strongly discourage above-cap filings by requiring carriers making such filings to show that their proposed rates are actually necessary to avoid confiscation.[1650] Michigan PSC finds 90 days to be too short a notice period,[1651] while Ohio PUC proposes that above-cap rates automatically be suspended, or that they not be allowed to take effect without regulatory approval.[1652] These pleadings are summarized in greater detail in Section III.C.4.d., supra.

799. Small LECs argue that, if they elect price caps, they should be permitted a lesser burden of proof in justifying above-cap rates.[1653] CBT and OPASTCO, for example, argue that events such as natural catastrophes or extraordinary equipment expenditures should justify relief from the extensive and rigorous cost showing that would otherwise be required.[1654]

iii. Discussion

1648 See, e.g., Ameritech Comments at 39-40.

1649 Id.

1650 Ad Hoc Comments at 15-16, 20. See also Colorado OCC Comments at 21.

1651 Michigan PSC Comments at 21-22. As noted previously, 90 days' notice is the maximum allowed by the Communications Act.

1652 As noted previously, the Communications Act allows suspension of rates for a maximum of five months.

1653 See, e.g., CBT Reply at 25-26; Independents Comments at 9; OPASTCO Comments at 21; USTA Comments at 18.

1654 CBT Reply at 25-26; OPASTCO Comments at 21.

800. In Section III we adopt for AT&T the procedures proposed in the Further Notice, with two modifications.[1655] The first modification, triggered by our recognition that it is not always possible to assign a cost to every rate element, is that AT&T need only make the required cost showing down to the lowest possible level. AT&T must still offer a detailed explanation of its rationale for pricing each rate element. We also modify the required showing to include an explanation of the allocation of costs among the baskets.

801. We tentatively conclude that LECs proposing rates above cap levels must meet the same filing requirements and make the same cost showings as AT&T. We also tentatively find that our price cap mechanism, including its additional backstop, should cause rates to track carriers' costs sufficiently well during the initial four year period that price cap regulation for the LECs should not lead to unreasonably low rates.

802. We also seek comment on whether there should be circumstances in which the burden to be met by small telephone companies should be different from that imposed on large companies, and on the justification for such different treatment. Comments on this issue should define which companies should be classified as small telephone companies for purposes of defining the burden to be discharged and describe both the proposed showing these carriers would be required to meet as well as the circumstances in which the commenter would propose the lighter burden to apply.

f. Below-band rate level changes

i. Summary of Further Notice

803. We proposed in the Further Notice that a tariff proposing to decrease rates by more than 5 percent be filed on 45 days' notice,[1656] accompanied by a showing that the rates cover the costs of providing service and are otherwise just, reasonble and nondiscriminatory.[1657] We proposed no specific cost standard by which we would determine whether the rates were predatorily low.[1658]

1655 See Section III.C.4.d, supra.

1656 Further Notice, 3 FCC Rcd at 3371-72 (para. 310).

1657 Id.

1658 Id. at 3372-73 (para. 311-12).

ii. Pleadings

804. Parties do not distinguish between AT&T and the LECs in their comments on our proposed tariff review procedures for below-band filings. NYNEX states that our proposal to allow below-band rates if they cover the cost of service is more than adequate,[1659] while GTOC asserts that, if we must impose some controls, the least damage would be done by using a standard that allows rates to fall to within some threshold percentage over marginal cost. Pactel and US West support the average variable cost standard.[1660] CBT recommends an incremental cost standard,[1661] while SWB advocates use of a standard based on incremental unit costs.[1662] Parties who see predation as a serious threat criticize the average variable cost standard as weak,[1663] complex,[1664] and manipulable.[1665]

iii. Discussion

805. In Section III we adopt our proposal to require that tariff filings proposing below-band rates be filed on 45 days' notice and be accompanied by a cost showing. We also adopt the average variable cost standard for purposes of determining whether a proposed rate decrease must be suspended pending investigation. We tentatively conclude that this same tariff review procedure and cost standard would be more than adequate to assure that LEC rate decreases are not predatory. We seek comment on this conclusion.

1659 NYNEX Comments at 21; accord Rochester Comments at 16.

1660 Pactel Comments at 49-50; US West Reply at 52.

1661 CBT Reply at 23.

1662 SWB Comments at 25-26.

1663 NTN Comments at 16-20.

1664 Comptel Comments at 24-25; Comptel Reply at 13.

1665 US Sprint Reply at 15.

f. New and restructured filings

i. Summary of Further Notice

806. In the Further Notice we recognized that new and restructured services can further innovation and efficiency, [1666] but that they can also be used to evade the protections built into the price cap plan against rate discrimination and anticompetitive conduct [1667] We therefore proposed to treat tariff filings for new and restructured services differently from filings which propose only rate level changes.

807. We proposed that an offering that increased a customer's options should be classified as new. An offering that represented only a change in an existing method of charging or offering, but did not increase the range of alternatives available to a customer, would be considered restructured. We also concluded that new services and restructured services each presented distinct problems which required procedures tailored to the issues likely to be raised by each type of filing.

808. We proposed that new services would not be subject to price cap regulation until the first annual filing after the completion of the base year in which the service offering became effective. To introduce a new service, the carrier would need to show that the service, and all unbundled elements thereof, met a modified version of the net revenue test set forth in the Commission's Optional Calling Plan Order.[1668] In order to afford adequate opportunity for review, we proposed that carriers file tariffs proposing new services on 45 days' notice.

809. For restructured services, we proposed that carriers file on 45 days' notice and make a showing that their proposed restructuring would not result in actual prices which fell outside price cap limitations. In addition, we proposed that the LECs be required to maintain the Part 69 rate structure for switched access services.

ii. Pleadings

810. New Services. In general, the LECs seek relaxation of our proposed approach to new services, while OCCs and other users doubt that our proposal contains adequate safeguards against discrimination and against unjustly or unreasonably high rates.

1666 See Further Notice, 3 FCC Rcd at 3376 (para. 322).

1667 Id. at 3377-78 (para. 325).

1668 Id. at 3376-77 (paras. 323-24).

811. Bell Atlantic, GTOC, US West, and USTA all take the position that the net revenue test should be applied to a proposed service as a whole, but not to unbundled rate elements.[1669] USTA argues that showing costs for individual rate elements would be economically meaningless, arbitrary, and burdensome; that application of the net revenue test to rate elements would discourage companies from offering new services; and that application of the test to unbundled rate elements would encourage undesirable bundling.[1670] Pactel asks us to clarify that the test would not apply to each rate element, but only to those offered separately.[1671]

812. Several LECs argue that we should extend the period of time within which the net revenue test would require a new service to increase revenues in its basket. BellSouth states that a new service might take off slowly because it takes a long time for customer acceptance to develop, or because full use of the service requires development of new equipment by CPE manufacturers.[1672] BellSouth asks that carriers be permitted to make a showing that a period longer than 36 months will be needed for a service to pass the net revenue test. Bell Atlantic argues that the "payback" period should be extended to at least 48 months for all new services because a new service that is more than just a repriced version of an existing service will need that much time to recover start-up costs and begin to turn a profit.[1673]

813. US West believes that new services should remain outside the cap altogether for at least five years, and possibly forever. According to US West, the longer waiting period is especially needed in the case of a new service that utilizes new technology. US West argues that, if new services must come within the cap quickly, a new-technology service would bear an unduly large share of the initial investment associated with the new technology. US West states that five years would allow use of "levelized"

1669 Bell Atlantic Comments at 6 n.12; GTOC Comments at 46-48; US West Comments at 49-52; USTA Comments at 31.

1670 USTA Comments at 31.

1671 Pactel Comments at 33-34.

1672 BellSouth Comments at 58-60. BellSouth notes that the BOCs are not permitted to manufacture equipment and must thus depend on non-affiliated companies to design and market any new equipment which might be needed for full use of a new network service.

1673 Bell Atlantic Comments at 6 n.12.

demand forecasts to spread that initial investment over future new services.[1674]

814. Several LECs express concern about the costing methodology to be used in connection with the net revenue test. USTA asks us to clarify that the incremental cost methodology adopted for use by AT&T is available to all carriers.[1675] Similarly, GTOC argues that there should be no allocation of joint costs in the net revenue test.[1676] CBT argues for annual, rather than quarterly, reporting, contending that requiring reports on services before they are capped would not be useful and would serve to discourage new service offerings.[1677]

815. Many of the parties who oppose extending price cap regulation to the LECs also oppose the proposed procedures for review of new service filings. They argue that the net revenue test is inadequate because it is designed to determine whether a proposed rate is predatorily low, and not to reveal whether a rate is unreasonably high. US Sprint, for example, claims that any new LEC services which lack competitive alternatives are likely to be priced excessively high,[1678] while IIA and EDS fear particularly that the net revenue test leaves the LECs free to exercise their market power in the pricing of new ONA services.[1679] AT&T's competitors also contend that the proposed procedures would not detect attempts by a LEC to offer a discriminatory volume discount to AT&T in the guise of a new service.[1680]

816. Pactel challenges the notion that new LEC services are likely to be overpriced, arguing that new service prices will be priced so as to stimulate demand and that, in any case, the proposed 45 day review period will allow ample time for the detection of excessive rates.[1681]

1674 US West Comments at 49-52; US West Reply at 46-49.

1675 USTA Comments at 31.

1676 GTOC Comments at 46-48.

1677 CBT Comments at 10-11.

1678 US Sprint Comments at 37 n.14.

1679 EDS Comments at 13-15; IIA Comments at 6.

1680 E.g., Comptel Reply at 18.

1681 Pactel Reply at 44-45.

817. Several parties argue for special treatment of new ONA services. Some propose that we leave ONA service offerings outside price cap regulation for longer than one year.[1682] The New Hampshire PUC urges that we delay price cap regulation completely until ONA is introduced.[1683] The telephone companies respond that such concerns are unfounded because ONA services, even as new services under price cap regulation, would continue to be governed by Computer III pricing rules.[1684]

818. Restructured Services. Most LECs apparently accept the need for non-streamlined review of restructured service filings, but believe they should be accorded greater flexibility to depart from Part 69 rate structures without first having to obtain a waiver.[1685] They claim that the 45-day notice requirement and other standards that would govern restructured service filings offer ratepayers adequate protection against anticompetitive or discriminatory rate structures.[1686] According to the LECs, the need to comply with Part 69 or obtain a waiver of those rules would hamper their ability to respond quickly to changing market conditions

---

1682 See Alarm Industry Comments at 2-7; TCA Comments at 22-23. Indeed, Alarm Industry's preferred solution would be to exclude ONA offerings from price cap regulation permanently, and subject such offerings to continued rate of return regulation.

1683 See New Hampshire PUC Comments at 8.

1684 See NYNEX Comments at 48 n.57; NYNEX Reply at 48, n. 78; USTA Reply at 20.

1685 See, e.g., Contel Comments at 13-15; GTOC Comments at 28-30; SNET Comments at 24; USTA Comments at 34; NYNEX Reply at 48; USTA Reply at 21-22.

1686 See, e.g., Contel Comments at 13-15.

or technology.[1687] Pactel argues that this Commission at least ought to reaffirm its willingness to entertain waivers of Part 69 requirements.[1688]

819. ICC and ICA, however, support retention of Part 69 rules governing access tariff rate structures, optional carrier common line tariffs and the relationship between rates for premium and non-premium access.[1689] Noting what it characterizes as past instances of attempted rate structure design abuses by the RBOCs, MCI expresses concern that the RBOCs might try to use rate restructuring as an anticompetitive tool.[1690] MCI states that continued applications of the Part 69 rules governing rate structure for access elements might help restrict the LECs' ability to price strategically.[1691]

iii. Discussion

820. In developing a price cap plan for AT&T, we have concluded that new and restructured services must receive special tariff review treatment because they present a means of avoiding pricing restrictions.[1692] We tentatively conclude that similar concerns require that we propose something other than streamlined review for LEC filings proposing new or restructured services. In Section III we have adopted for application to AT&T the general principle for distinguishing new from restructured service proposed in the Further Notice.[1693] We discuss at length in that section the

---

1687 See, e.g., SNET Comments at 24; USTA Comments at 34. In addition, several parties argue that NECA ought to be granted pricing flexibility and rate structure flexibility in the administration of the common line and traffic sensitive pools to benefit those LECs remaining under rate of return. Parties argue that unless flexibility is granted, those carriers remaining under rate of return will be subject to the most onerous regulatory requirements, and that the small size of those companies likely to remain in the pools does not justify the level of regulation. NECA Comments at 5, 12-14; OPASTCO Comments at 5-6; TDS Comments at 2, 16; Century Comments at 14. See also NRTA Comments at 9-10; OPASTCO Reply at 6-7; Independents Reply at 18; NTCA Comments at 13-14.

1688 Pactel Comments at 58-59.

1689 ICC Comments at 8; ICA Comments at 32.

1690 MCI Comments at 35-39.

1691 MCI Comments at 76 n.118.

1692 See Section III.C.4.f, supra.

1693 See id.

characteristics that distinguish a restructured service from a new service,[1694] and determine that a touchstone for distinguishing between the two kinds of service is the continued availability of the previously-tariffed alternative. We also note that a 45-day notice period will permit us to determine whether the carrier's characterization of a filing is correct. In our price cap plan for LECs, we propose to use the same principles to distinguish between new and restructured LEC offerings. We solicit comment on this tentative conclusion.

821. New services. For AT&T we have concluded that tariffs proposing new services should be filed on 45 days' notice with data that demonstrates compliance with a modified version of the net revenue test first adopted in the Optional Calling Plan Order.[1695] After modifications designed to reflect differences between price cap and rate of return regulation, the net revenue test applies as follows to AT&T's new services:

Net Revenue Standard.

(a) A new service, and each unbundled element thereof, must be projected to increase AT&T's net revenues for services subject to price cap regulation.

(b) The increase must be projected to occur within the lesser of the following time periods: 24 months from the incorporation of the service into an annual price cap filing, or 36 months from the effective date of the service.

Required Showing.

(a) Revenue effects shall be measured on a present value basis.

(b) AT&T shall support its net revenue projections with detailed information on demand, cost, revenues, elasticity, and cross-elasticity of demand associated with the new service.

1694 See id.

1695 See Section III.C.4.f, supra.

(c) All assumptions, estimates, and cost allocation methods employed in developing that information shall be fully explained.

Reporting.

AT&T must file quarterly reports comparing actual operating results with projections, beginning six months after the initiation of the new service.

We did not require that each rate element satisfy the net revenue standard, but we did require AT&T to demonstrate that the new service imposes no unreasonable restriction on customer resale, sharing or interconnection. We rejected requests of carriers for more relaxed treatment of new services, and in particular for a longer "payback period."[1696]

822. The net revenue test we have imposed upon AT&T's new service offerings would answer many of the concerns raised by some commenters about LEC new service offerings outside of price cap regulation. In particular it appears that such a test could assuage concerns that in those service markets for which the LECs were subject to some competition, e.g., high capacity facilities in urban areas, new services might enable a LEC to propose predatorily or discriminatorily low rates to certain customers.[1697] For this reason, we tentatively conclude that LEC filings proposing new services be required to satisfy a test like that we have adopted for AT&T. We seek comment on whether the AT&T net revenue test would adequately address the concern that new LEC services not become a vehicle for anticompetitive or discriminatory behavior.

823. We acknowledge and share the concerns of the parties who point out that, unlike AT&T, the LECs may be in a position to charge unjustly or unreasonably high prices for some new services for which there may be no competitive alternative. We tentatively conclude, however, that the data submitted in satisfaction of the net revenue test will be sufficient to allow this Commission and interested parties to determine whether proposed rates for a new service are outside the zone of reasonableness. We further tentatively conclude that the 45 days' notice period will give us ample opportunity to decide whether it is necessary to reject, suspend, or investigate any tariff filing which implements a new service. We seek comment on these tentative conclusions.

1696 See id.

1697 See, e.g., NTN Comments at 34; ALC Comments at 18.

824. Various parties suggest that ONA services should be treated differently from other access services under a price cap regime in order to avoid disturbing our Computer III policies. We tentatively conclude, however, that ONA services, which may be new, restructured, or even existing services[1698], should be treated for tariff review purposes the same as other new, restructured, or existing services.[1699]

825. Restructured services. We have concluded that when AT&T files a tariff proposing to restructure a service within one of the price cap baskets, its tariff should be filed on 45 days' notice. Since other safeguards in the AT&T plan already protect against the possibility of predation, the focus of our concern would be upon the possibility of unreasonable discrimination.[1700] We have tentatively concluded that our basket and subbasket approach, and our price bands, would adequately address concerns about LEC predation.[1701] We would therefore propose to require that when a LEC submits a tariff filing that would restructure an existing capped service, it be required to show compliance with the price cap and banding limits of the basket, and where applicable, of the subbasket, to which the service to be restructured belongs. In addition, its filing would be subject to the conventional 45-day tariff review period to assure that the restructuring did not produce unreasonable discrimination among service users or did not have any other anticompetitive effects.

826. Finally, we tentatively find that price cap carriers should continue to adhere to the rate structure requirements of Part 69 for the switched access elements.[1702] A primary purpose of the rate structures embodied in Part 69 is to eliminate unreasonable discrimination between service users. When these service users are interexchange carriers or enhanced service providers, these rules also promote competition in two

---

1698 See Filing and Review of Open Network Architecture Plans, CC Docket 88-2, Phase I, 4 FCC Rcd 1 (1988) at paras. 276-82.

1699 As discussed in Section IV.C.2.b, we do invite comment on whether unbundled services offered pursuant to separate Part 69 subelements, such as BSEs, should be subject to banding limitations.

1700 Since for this type of service filing, AT&T would still need to demonstrate compliance with both price cap and price band limits, it cannot use restructuring as a vehicle for evading the limit on rate increases imposed by price cap regulation.

1701 See Section IV.C.2.b, supra.

1702 This Commission does not mandate a rate structure for special access. Section 69.113 of this Commission's Rules, 47 C.F.R. § 69.113.

markets in which this Commission has concluded that a competitive market structure will promote the public interest. In the face of the significant market power retained by LECs in the provision of interstate access, rules that discourage unreasonable discrimination and its potentially adverse effect on competition in interstate communications markets should be given precedence over the benefits that might come from LECs' ability to depart from the Part 69 rules prescribing rate structures for access elements. We continue to believe that the waiver process offers a better forum than the tariff review process for identifying and weighing the advantages and disadvantages that accompany departures from those rules. For this reason, we also tentatively conclude that unless a LEC first obtains a waiver of Part 69 rules, its price cap filings must continue to comply with the sections of that part prescribing the structure of interstate access elements, including those setting the guidelines for optional carrier common line tariffs and the relationship between rates for premium and non-premium access.

D. Small Company Issues

827. This section deals with issues related to how small companies might be affected by the implementation of a price cap system of regulation that is mandatory for Tier 1 companies that have elected to leave the NECA common line pool and optional for companies below the Tier 1 level that choose to leave the NECA pool. In previous Sections of this Notice, we have already discussed several small company concerns: (1) opportunities for small carriers to elect price cap regulation, in Section IV.B.5; (2) treatment of equal access costs as an exogenous factor, in Section IV.C.1.a;[1703] and (3) the selection of a productivity number for LECs of different sizes, in Section

---

1703 Although treatment of equal access conversion costs is not strictly a concern of small carriers, most of the larger LECs have made substantial progress toward implementing their equal access obligations under various consent decree obligations. Non-BOC and non-GTOC carriers are obligated to convert to equal access pursuant to directives issued by this Commission, although the conversion requirements are dependent upon customer requests for equal access conversion, and therefore are not tied to the type of conversion timetable to which the RBOCs are subject. MTS and WATS Market Structure, CC Docket No. 78-72, Phase III, Report and Order, 100 FCC 2d 860 (1985). As a result, many of the smaller carriers have not yet begun or are just beginning the process of converting to equal access.

IV.C.1.c.[1704] In addition to the issues previously addressed, two other significant small company concerns remain. The first is the preservation of high cost support and universal service mechanisms in a price cap environment. The second is how price cap regulation of LEC access charges might affect the ability of interexchange carriers to continue to geographically average their rates.

1. Continuation of programs promoting universal service

a. Summary of Further Notice

828. The Further Notice proposed several significant modifications to Parts 65 and 69 of this Commission's rules that were intended to alleviate administrative burdens on carriers electing price cap regulation. For carriers electing price caps, we proposed that no prescribed rate of return be applied to their investments for the purpose of calculating a revenue requirement, and specifically excluded them from Sections 65.200 and 65.703(a), (e), and (f).[1705] We also proposed to add new sections to Part 65 defining the close of the final period for which the earnings of LECs subject to price cap regulation would be reviewed under rate of return standards, and presenting a mechanism through which they could discharge refund obligations incurred at the time they were still regulated under rate of return.[1706] Appendix E of the Further Notice also presented proposed new

---

1704 In Section IV.B.4, we discuss the application of price cap regulation to average schedule companies and their affiliates. While we tentatively conclude that price cap regulation should not apply to average schedules, we also tentatively decided that average schedule affiliates of price cap carriers need not relinquish average schedule and rate of return regulation. Small companies have also raised concerns about the continuation of a prescribed access structure, once large carriers move to price cap regulation. That issue is dealt with in the section on LEC new and restructured services, supra.

1705 3 FCC Rcd at 3467 (para. 509). Section 65.200 contains requirements for data collection for the purpose of establishing an authorized rate of return. Section 65.703 concerns the methodology used to effectuate refunds under the rate of return system.

1706 Id. at 3467 (para. 509).

sections within Part 65 prescribing the form and content of annual reports to be filed by LECs subject to price cap regulation in which they would state their total earned interstate rate of return for the preceding price cap year.[1707] Carriers not electing price cap regulation would remain under existing rate of return constraints.[1708]

829. In addition to proposing changes to Part 65's rate of return requirements, the Further Notice proposed changes to Part 69's access charge requirements. We tentatively found that carriers regulated under price caps would continue to be subject to those Part 69 rules prescribing rate structures for access services, but would not be required to comply with the rules prescribing rate level calculations based on rate of return concepts.[1709] Proposed amendments to Part 69 would free LECs regulated under the proposed price cap plan from the obligation to follow the cost allocation rules of Part 69, but would require them to allocate exogenous costs among the baskets of services on a cost-causative basis.[1710] Carriers that do not elect price cap regulation would continue under the existing Part 69 access rules.[1711]

b. Pleadings

830. Telephone companies commenting on the proposed changes to Parts 65 and 69 are unanimous in their concern that the amendments we proposed would interfere with the calculation of a unitary rate of return for the industry, which in turn would prevent the calculation of long term support payments that are an integral part of the pooling modifications that become effective in April, 1989.[1712] Many LECs argue that the data collection mandated by

---

1707 The proposed amendments also would have retained rate of return regulation for the common line access element and prescribed the reporting requirement arising from the continued rate of return regulation of that element. The proposed continuation of rate of return regulation for common line stemmed from the tentative decision to hold common line outside of price caps for one year from the inaugural date of the new regulatory system, a plan that has been abandoned in view of our new proposal to initiate price cap regulation for all eligible LECs and LEC services in July, 1990 instead of a partial implementation in April, 1989 that would have excluded common line.

1708 3 FCC Rcd at 3467 (para. 509).

1709 3 FCC Rcd at 3469 (paras. 514-15).

1710 Id. (para. 515).

1711 Id. (para. 514).

1712 See MTS and WATS Market Structure and Amendment of Part 67 of the

Section 65.200 of this Commission's rules is necessary to the formulation of a nationwide rate of return.[1713] LECs state that without a rate of return, a nationwide common line revenue requirement cannot be derived, and the nationwide average carrier common line charge needed to derive long term support payments, could not be calculated.[1714] LECs also point out that a rate of return number is necessary to conduct revenue requirement calculations for other programs promoting universal service, such as the Universal Service Fund.[1715]

831. LECs argue that a unitary, nationwide rate of return is essential under existing Part 65 requirements if carriers not electing price caps are to continue under rate of return regulation.[1716] Under existing procedures, data collected from the RBOCs are utilized, along with comparable firm data submitted by the RBOCs, to derive a single rate of return number for the LEC industry.[1717] The LECs argue that if the RBOCs no longer need to submit data pursuant to Part 65 requirements, other mechanisms would have to be found to calculate a rate of return, which presumably would place greater burdens on

---

Commission's Rules, CC Docket Nos. 78-72 and 80-286, Report and Order, 2 FCC Rcd 2953, 2956-59 (1987) (Pooling Order), recon., 3 FCC Rcd 4543 (1988) (Pooling Order Reconsideration), pet. for review pending, Public Service Comm'n of D.C. v. FCC, D.C. Cir., Case No. 88-1661 (pet. filed Sept. 12, 1988).

1713 Illinois Consolidated Comments at 6-7; Independents Comments at 15-16; NECA Comments at 8; NRTA Comments at 2,4; NTCA Comments at 15; OPASTCO Comments at 4; TDS Comments at 2, 10-11; NYNEX Comments at 44 n.51; BellSouth Comments at 11, n. 14; Pactel Comments at 60-61; Century Comments at 12, 16, 19; USTA Comments at 22-23; OPASTCO Reply at 2, 7; TUECA Reply at 5.

1714 NECA Comments at 4-5, 8-9; OPASTCO Comments at 4; NRTA Comments at 4, 7; TDS Comments at 13-14; Century Comments at 17-18; OPASTCO Reply at 7; TDS Reply at 8-9; Independents Reply at 16; TUECA Reply at 5. See also Florida PSC Reply at 6.

1715 E.g., NRTA Comments at 4, 7; TDS Comments at 13-14; Century Comments at 17-18.

1716 E.g., NECA Comments at 8-9.

1717 See generally Part 65 of this Commission's Rules, 47 C.F.R. Part 65. This procedure is currently under review in CC Docket No. 87-463, where this Commission is considering changing our rate of return procedures. Refinement of Procedures and Methodologies for Represcribing Interstate Rates of Return for AT&T Communications and Local Exchange Carriers, CC Docket No. 87-463, Notice of Proposed Rulemaking, 2 FCC Rcd 6491 (1987).

smaller LECs for submission of data.[1718] As a result, the LECs -- including the RBOCs -- favor retaining existing data collection rules that apply only to the largest exchange carriers.[1719]

832. The LECs also argue, however, that while data filing requirements ought to apply to only the largest of their number, we should suspend the current Part 65 schedule for submitting cost of capital data and retain the current authorized rate of return for LECs.[1094] They urge us during this period to turn our attention to simplifying the procedures upon which we relied to represcribe a rate of return for those LECs remaining under existing regulation.[1720] These commenters argue that an open docket dealing with rate of return represcription issues ought to be resolved in conjunction with the price cap proceeding.[1721] TDS states that represcription in the near term is

---

1718 TDS Reply at 9.

1093 NECA Comments at 9; TDS Comments at 12-13; GTOC Comments at 52; SWB Comments at 34-5; Ameritech Comments at 10, n.4; Bell Atlantic Comments at 10, n. 19; US West Comments at 55, n. 149. See also ICA Comments at 21-22 (favoring retention of all cost and earnings reports in their current form).

1719 NECA Comments at 11; NRTA Comments at 5; TDS Comments at 12; USTA Comments at 20-21; Pactel Comments at 61; Century Comments at 11, 18; GTOC Comments at 52; SWB Comments at 34; Ameritech Comments at 10, n.4; Bell Atlantic Comments at 10, n.19; US West Comments at 55, n. 149; BellSouth Comments at n. 14; Illinois Telco Comments at 6-7; Independents Comments at 6-7; SNET Comments at 32-33; Rochester Reply at 33; OPASTCO Reply at 8. See also NTCA Reply at 4-5 (existing rate of return should remain in effect until after price cap elections are complete, data collection questions are resolved, and represcription issues are finalized). But see MCI Comments at 7, 16 (current rate of return is excessive); ICA Comments at 13 (current rate of return may be excessive).

1720 OPASTCO Comments at 7; NRTA Comments at 4-5; SWB Comments at 35; USTA Comments at 22-24; BellSouth Comments at 11, n.14; Ameritech Comments at 10, n.4; Bell Atlantic Comments at 10, n.19; US West Comments at 55, n. 149; Centel Comments at 17-18; Illinois Consolidated Comments at 4-5; Independents Comments at 14; NECA Comments at 10, 12; NTCA Comments at 3 n.1; Century Comments at 10-11; SNET Reply at 23; TUECA Reply at 5. Several of these commenters urge us to expand our streamlined filing procedures for small companies' traffic sensitive rates to small companies' other access rates. See USTA Comments at 23-24; TDS Comments at 17-18; Century Comments at 13; Illinois Consolidated Comments at 5; Independents Reply at 15-16. Some commenters urge us to represcribe a rate of return after the initial four year period of price caps. Pactel Comments at 61-62; SNET Comments at 33.

1721 E.g., NTCA Reply 5-7. See also Illinois Consolidated Comments at 6.

unnecessary since underlying economic factors do not compel the rate to be lowered.[1722]

833. Several companies also express concern that by eliminating Part 69 requirements that carriers allocate interstate access investment and expense at the rate element level, our proposed rules would prevent the calculation of a common line revenue requirement needed to derive long term support obligations.[1723] According to these parties, the cost allocations mandated by Sections 69.301-310 and 69.401-414 are essential if a common line revenue requirement is to be separated from the revenue requirement associated with traffic sensitive functions and special access.[1724]

c. Discussion

834. Throughout the development of access charges for LECs, this Commission has been concerned with protecting and promoting the provision of universal telephone service for all Americans. Our concern has evidenced itself in a number of programs that provide assistance to small and high cost telephone companies and their subscribers, as well as to low income

---

1722 TDS Reply at 9-10.

1723 NECA Comments at 10-13; NTCA Comments at 13-14; USTA Comments at Att. B.

1724 Id.

subscribers generally. Programs such as Link Up America,[1725] Lifeline Assistance,[1726] the Universal Service Fund,[1727] Long Term Support,[1728] and Transitional Support[1729] share a common purpose of promoting affordable telephone service throughout the nation. These programs have, of course,

---

1725 Pooling Order, 2 FCC Rcd at 2958, modified, MTS and WATS Market Structure, Link Up America and Amendment of Part 36 of the Commission's Rules, CC Docket No. 88-341, FCC 89-78, released February 27, 1989. Link Up America is a program of federal assistance that offsets one-half of the charges for commencing telephone service (i.e., service installation and connection charges), up to a total of $30 in assistance, for qualifying households. Link Up America also encourages LECs to offer deferred payment schedules for these charges by paying a LEC's interest costs on an amount up to $200. Id. at 2955. Sections 36.701 through 36.741 of this Commission's Rules, 47 C.F.R. §§ 36.701 - 36.741. The Link Up America program is funded by charges assessed on interexchange carriers. Pooling Order, 2 FCC Rcd at 2955 & 2957-59 (modifying the method by which interexchange carriers are billed for these costs); Pooling Reconsideration Order, 3 FCC Rcd at 4553; Amendment of Part 69 of the Commission's Rules Relating to the Assessment of Charges for the Universal Service Fund and Lifeline Assistance, CC Docket Nos. 78-72 and 80-286, 4 FCC Rcd 2041 (1988) (Further Notice on USF and Lifeline Cost Recovery); Section 69.117 of this Commission's Rules, 47 C.F.R. § 69.117.

1726 MTS and WATS Market Structure and Amendment of Part 67 of the Commission's Rules, CC Docket Nos. 78-72 and 80-286, Decison and Order, 51 Fed. Reg. 1371 (1986), aff'd on recon., 1 FCC Rcd 431 (1986), modified, Pooling Order, 2 FCC Rcd at 2955-56 & 2957-59; Pooling Reconsideration Order, 3 FCC Rcd at 4552-53. Under the Lifeline Assistance plan, qualifying subscribers are exempted from all or part of the subscriber line charge to the extent of matching state assistance provided to such subscribers pursuant to a qualified state plan. Section 69.104(k) of this Commission's Rules, 47 C.F.R. § 69.104(k). See also Section 69.104(j) of the Commission's Rules, 47 C.F.R. § 69.104(j). Like the Link Up America plan, Lifeline Assistance is financed by charges on interexchange carriers. Pooling Order, 2 FCC Rcd at 2955 (modifying method of billing IXCs for these costs); Pooling Reconsideration Order, 3 FCC Rcd at 4553; Further Notice on USF and Lifeline Cost Recovery, 4 FCC Rcd 2041 (1988); Section 69.117 of this Commission's Rules, 47 C.F.R. § 69.117.

1727 The Universal Service Fund operates to keep local service rates low by providing assistance to carriers in high cost areas. Universal Service Fund payments are calculated from nonseparated loop costs for all LECs using cost based separations and are recovered from the interexchange carriers. Amendment of Part 67 of the Commission's Rules, CC Docket No. 80-286, 96 FCC 2d 781 (1984), aff'd sub nom. Rural Telephone Coalition v. FCC, 838 F.2d 1307 (D.C. Cir. 1988), modified, MTS and WATS Market Structure and Amendment of Part 67 of the Commission's Rules, CC Docket Nos. 78-72 and 80-286, Decision and

grown up around rate of return regulation. As a consequence, the rules that implement these programs employ rate of return concepts and requirements that involve the calculation of various types of revenue requirements.[1730]

835. In adopting price cap regulation, we do not intend to compromise any of these important programs. Nor do we believe that price cap regulation makes it necessary for us to do so. Each of these programs can and will continue intact under the price cap system we are proposing for LECs in this order.

836. We also believe that price cap regulation should not disturb our longstanding practice of employing a unitary rate of return for the local exchange industry, thereby ensuring that access rate determinations for those remaining under rate of return and the support mechanisms associated with access charge revenue requirements are unaffected by the implementation of a price cap system. Because the continuation of a unitary rate of return

---

Order, 50 Fed. Reg. 939 (1985), recon. FCC 86-56, released Jan. 30, 1986. Sections 36.601 through 36.641 and Section 69.116 of this Commission's Rules, 47 C.F.R. §§ 36.601-36.641 & 69.116. In 1987, we retargeted the benefits provided by this program to provide additional assistance to small and medium-sized high cost companies. Pooling Order, 2 FCC Rcd at 2955-59.

1728 Long Term Support is a mechanism for ensuring that LECs remaining in the common line pool will not be worse off after April 1, 1989, when LECs can withdraw from the common line pooling arrangement and file individual common line charges. To determine the amount of long term support that those remaining in the NECA pool will need, an industry-wide common line revenue requirement must be calculated. Pooling Order, 2 FCC Rcd at 2956-59; Sections 69.2(y) and 69.612(a) of the Commission's Rules, 47 C.F.R. §§ 69.2(y) & 69.612(a).

1729 Transitional support will be paid to those LECs that withdraw from the common line pool and that were "net receivers" of access revenue under the pooling arrangement. Transitional support is calculated based on 1988 revenues and costs for net receivers, and will be phased out over several years. Pooling Order, 2 FCC Rcd at 2956-59; Sections 69.2 (u) and (w), and 69.612(b) of this Commission's Rules, 47 C.F.R. §§ 69.2 (u) & (w), & 69.612(b).

1730 The concern about continuation of a unitary rate of return and the calculation of revenue requirements for the continuation of universal service programs is obviously an issue affecting more than just small exchange carriers and their subscribers. The entire industry participates in the programs we have adopted to promote universal service. While these issues are of utmost importance to small carriers, the tentative decisions we reach in this section are intended to apply to all LECs, regardless of size.

permeates the discussion of the universal service and support programs we have enacted, we turn first to consideration of the issues raised in the comments concerning continuation of a rate of return prescription.

837. Continuation of a rate of return prescription in some form is essential for two reasons. First, carriers remaining under existing regulation require a rate of return to make their revenue requirement and rate calculations. Second, all carriers employ a rate of return in calculating their obligations under some of the universal service programs we have adopted. Carriers operating under price caps, however, should not be held to the same rate of return earnings limitation as those carriers operating under rate of return regulation. Indeed, to do so would be inconsistent with the incentive structure we are creating. Therefore, we tentatively affirm our previous proposal to exempt price cap carriers from interstate earnings limitations imposed as part of the rate of return process. Price cap carriers will no longer be required to target rates to earn the authorized rate of return, nor will they necessarily be faulted in the complaint process or elsewhere for exceeding the rate of return prescribed for other carriers or other purposes.

838. We also propose to require that price cap carriers employ the existing rate of return in calculating their obligations under the various universal service programs we have adopted whenever a rate of return is necessary as part of the calculation. In addition, we will not here amend the data filing requirements currently imposed on carriers for setting our rate of return prescription. We agree with the industry that the adoption of price cap regulation should not create new filing burdens on those carriers that elect to remain under rate of return. And, we plan to address in the context of a rate of return docket how the rate of return process should be streamlined after the implementation of price caps.

839. We tentatively disagree with those commenters who would have us suspend the rate of return represcription procedures and continue to apply the existing rate of return of 12 percent to LECs during the initial four years of price cap regulation. Rate of return prescriptions are intended to reflect current economic conditions. Extending the existing rate of return out another four years may or may not result in just and reasonable rates. We prefer to let the represcription process take its course.

840. We also continue to propose amendments to Part 65 that would specify the last rate of return reporting period for carriers switching to price cap regulation, as well as providing a transitional mechanism for refund obligations for price cap carriers incurred during a pre-price cap period. We seek comment on whether the revisions of Part 65 we now propose would be necessary and sufficient to integrate and harmonize the introduction of price caps with our continued reliance on rate of return regulation for at least one segment of the telecommunications industry, those telephone companies remaining in the NECA pools.

841. With respect to Part 69, we tentatively conclude that any amendments we make to our access charge rules to accommodate price cap regulation must not interfere with the support mechanisms that become effective pursuant to our Pooling Order.[1731] As commenters have correctly pointed out, the calculation for Long Term Support payments from those exiting the NECA common line pool to those carriers remaining in the pool requires a common line revenue requirement for the industry.[1732] We therefore tentatively find that it is necessary to allocate access investment and expense between common line and other interstate services, i.e., interexchange, billing and collection, and the traffic sensitive access elements. We propose to amend the cost allocation requirements contained in Sections 69.301-310 and 69.401-414 to require price cap carriers to allocate investment and expense between common line costs and all other access costs. We seek comment on whether there is an alternative way to assure the continued success of long term support payments, one that would not require continued application of these sections to those LECs regulated under price caps. Those comments claiming that such an alternative exists should describe both the alternative they propose and how it would assure the continued successful operation of long term support.

842. We also seek comment on our proposal to require carriers to allocate exogenous costs between baskets on a cost causative basis. As we did in the Further Notice, we propose to adopt Section 69.415 containing language directing carriers to allocate exogenous costs on a cost causation basis.

2. Geographic rate averaging

a. Summary of Further Notice

843. The Further Notice expressed our commitment to geographic rate averaging as a policy that has proven to be effective in protecting rural ratepayers and customers of high cost LECs from unduly large common line cost recovery burdens, and that has permitted rural ratepayers to share in the benefits of increased interexchange competition.[1733] We proposed not to adopt any specific prohibitions against rate deaveraging, however, because we found that carriers will continue current practices without adoption of a Commission rule.[1734]

1731 2 FCC Rcd 2953.

1732 See Section 69.612(a) of this Commission's Rules, 47 C.F.R. § 69.612(a).

1733 3 FCC Rcd at 3450-51 (para. 480).

1734 Id. at 3452 (paras. 484-85).

b. Pleadings

844. In the section adopting a price cap plan for AT&T, we summarized comments concerning the effect price caps would have on geographic rate averaging.[1735] We noted that parties generally support geographic rate averaging as a means of attaining our goal of fostering universal service. In that section, we also noted that a number of parties argue that we should elevate our policy favoring geographic rate averaging to a rule prohibiting AT&T from deaveraging. This argument was strongly supported by a number of parties representing small LECs.[1736]

845. Several of the comments summarized in the section dealing with AT&T illustrate the distinction that exists when price cap regulation is considered for use as an access cost recovery mechanism, as opposed to applying price caps solely to AT&T. For example, two parties argue that price caps, coupled with the upcoming depooling of carrier common line charges, will increase pressures on AT&T to deaverage, due to differences in carrier common line charges among LECs established by depooling and the pricing flexibility that is built into a price cap system.[1737] Hawaii argues that it is not clear if the limits to pricing flexibility contained in a price cap system are sufficient to prevent geographic rate deaveraging.[1738] Alaska states that geographic rate averaging is a function of rate of return and pooling mechanisms, and that there is no guarantee that AT&T would continue to average rates if all dominant carriers moved to a price cap system.[1739]

846. Several commenters note AT&T's statement in the record that "AT&T is committed to continuing geographic averaging of toll rates, but any further de-averaging of the rates for exchange access authorized by the Commission would logically require that AT&T have the flexibility to de-average interexchange rates to reflect those access costs, at least to the extent its competitors de-average their rates."[1740] Some parties interpret AT&T's

---

1735 See Section III.D.1, supra.

1736 See TDS Comments at 2, 15; NTCA Comments at 18-19; Century Comments at 12; USTA Reply at 48; Independents Reply at 18-19; NECA Reply at 11-12; TDS Reply at 10; Telephone Utilities Reply at 6; OPASTCO Reply at 9-10.

1737 Wisconsin Comments at 2; TDS Comments at 15.

1738 Hawaii Comments at 17.

1739 Alaska Comments at 3.

1740 AT&T Comments at 7 n.*.

statement as establishing no real commitment to geographic rate averaging since AT&T states that disparities in LEC charges may trigger deaveraging.[1741] Pactel, however, argues that price caps will not prompt geographic rate deaveraging.[1742] In support of its argument, Pactel states that AT&T has paid deaveraged traffic sensitive charges for the past five years without threatening to deaverage its rates, and that AT&T did not threaten to deaverage rates at the time the decision was made to modify the carrier common line pooling mechanisms.[1743] AT&T, in its reply, also states that price caps will not add to pressures to deaverage its rates, and that other Commission policies affecting access charges are much more determinative of the outcome on this issue.[1744]

c. Discussion

847. As part of our decision adopting price caps for AT&T, we reaffirmed our policy in favor of geographically-averaged MTS rates, and concluded that implementing price caps for AT&T would not undermine that policy. We here tentatively conclude that implementing our revised price cap proposal for the LECs also would not endanger geographic rate averaging.

848. This Commission has repeatedly demonstrated our dedication to geographic rate averaging of toll calls on the public switched network, through our various decisions affecting recovery of common line costs. LEC interstate access costs vary from carrier to carrier, often widely. This Commission currently administers a series of policies and rules designed to ensure that these cost differences do not put pressure on interexchange carriers to geographically deaverage MTS rates. The bulk of these policies and rules take the form of technical provisions within Part 69 of the Commission's rules, and include Unity 1-A safeguards adopted by this Commission two years ago. These policies and rules are the result of a series of Commission decisions made during the past six years in notice and comment rulemaking proceedings.[1745]

1741 Alaska Comments at 3-4; Alascom Reply at 5; Missouri Comments at 8-9 (arguing that AT&T is actively pursuing deaveraging at the state level).

1742 Pactel Comments at 54.

1743 Id. at 24-25.

1744 AT&T Reply at 25.

1745 See, e.g., MTS and WATS Market Structure, Third Report and Order, CC Docket No. 78-72, 93 FCC 2d 241 (1983)(Access Charge Order); MTS and WATS Market Structure, Recommended Decision and Order, CC Docket Nos. 78-72 and 80-286, FCC 87J-1, 2 FCC Rcd 2324 (Joint Board Order); MTS and WATS Market

849. In 1983, for example, this Commission adopted its access charge plan that establishes the rate structure all LECs must follow in recovering their costs of providing switched interstate basic services. The plan established two main categories of LEC charges for the recovery of costs that affect rate averaging: (1) traffic sensitive charges; and (2) the carrier common line charge. In conjunction with adopting the plan, this Commission determined that the public interest did not require LECs to participate in cost pooling and joint tariffing arrangements with regard to their traffic sensitive charges, but that cost pooling and joint tariffing arrangements would be required for LEC common line cost recovery. This Commission made these determinations in large measure because it concluded that a cost pooling and joint tariffing arrangement for common line costs was necessary at that time to prevent undue pressures on interexchange carriers to deaverage their rates because of the then-existing disparities among LECs with regard to common line costs.[1746]

850. In line with this Commission's legal obligation to review its policies and rules from time to time to ensure they continue to further the goals they originally were designed to achieve, this Commission in 1986 asked a Federal-State Joint Board to review certain portions of the access charge plan, including cost pooling and joint tariffing arrangements for carrier common line cost recovery. The Joint Board, which was comprised of four state commissioners and three FCC commissioners, conducted a proceeding in accordance with notice and comment procedures, considered the issues referred to it, and issued a series of recommendations to this Commission. These included a recommendation that this Commission modify the pooling requirement in a way that preserves an interexchange carrier's incentives to maintain geographically averaged rates, yet permits individual LECs greater flexibility to tariff rates based on their own cost of service.[1747] With minor exceptions, this Commission subsequently adopted the Joint Board's recommendations.[1748]

851. In making their determinations about pooling and LEC averaging, this Commission and the Joint Board listened carefully to the concerns expressed by proponents of geographically averaged rates and went to great lengths to craft policies that would preserve geographic rate averaging by

---

Structure, Report and Order, CC Docket Nos. 78-72 and 80-286, 2 FCC Rcd 2953 (1987)(Pooling Order).

1746 See Access Charge Order, 97 FCC 2d at 326-30.

1747 See Joint Board Order, 2 FCC Rcd 2324 (1987).

1748 See Pooling Order, 2 FCC Rcd 2953 (1987).

maintaining significant limits on the disparity in access rates that interexchange carriers have to pay to different local exchange carriers.[1749]

852. We here propose no changes to existing rules and procedures governing the pooling process, including the rules governing transitional and long term support payments. Also, no changes are proposed to rules and procedures commonly associated with the pooling process or necessary to assure that the pools can continue to be administered effectively, such as the Uniform System of Accounts (USOA) and current jurisdictional separations rules. In addition, we are proposing no changes in the rules governing the administration of the Commission's High Cost Fund support program, including the rule amendments adopted by the Commission that target more support for small telephone companies.

853. Most of the LEC pricing flexibility that concerns commenters supporting geographically averaged rates stemmed from our proposal in the Further Notice to combine CCLC and traffic sensitive charges in a single basket for price cap purposes. Under that proposal, LECs could have raised or lowered their CCLC charges by 5 percent per year, so long as rate change were offset by changes in traffic sensitive prices, and the aggregate did not peirce the cap. Under the revised proposal contined in this Notice, however, LECs must segregate common line in its own basket. Since most of the common line charges are fixed or determined by Commission rule, and not subject to price flexibility under caps, LECs have no ability above and beyond the cap on common line charges to raise the CCLC once a price cap system of regulation is initiated. Stated differently, in any given year, the CCLC can only change in accordance with the cap on the common line basket; no banding of rates is possible.[1750] Furthermore, as we have previously discussed in Section IV.C.1.c, supra, the cap we propose for common line costs will, we believe, operate in an aggressive manner to bring CCLC prices down under a price cap regime.

1749 Our recent decision to require most LECs to charge a one cent originating premium CCLC serves to limit the geographic disparities that might undermine geographically averaged rates. MTS and WATS Market Structure, CC Docket No. 78-72, FCC 88-399, released Dec. 12, 1988.

1750 Our recent decision to set originating CCLC premium rates at one cent per minute (or if less that one cent, require originating and terminating CCLC charges to be equal) does not alter our tentative conclusion. See Id. In fact, by requiring most LECs to recover one cent per minute from originating CCLC, we have ensured that a LEC under price caps cannot reprice originating and terminating access under the banding requirements that apply, for example, to the traffic sensitive elements.

854. In addition, as we noted in our discussion of the AT&T price cap plan, any deaveraging of rates would constitute a non-streamlined rate restructuring by AT&T, and would have to be made in the context of a public tariff proceeding, subject to suspension and investigation, as well as the participation of all interested parties. Given our strong commitment to geographic rate averaging, however, we believe that any AT&T proposal to deaverage rates would raise significant issues affecting the achievement of the universal service goals embedded in the Communications Act. We therefore pledge that any AT&T tariff that proposes to deaverage rates will be subject to the full 90-day notice period provided under Section 203 of the Communications Act, and will be suspended for the full five-month period provided for under Section 204 of the Act. We also pledge to investigate any such filing by AT&T. In the course of such an investigation, AT&T would bear the burden of justifying its proposal, and, given our strong commitment to geographically averaged rates, the showing we will require will be difficult to meet. Thus, AT&T will face this Commission's fullest scrutiny, a lengthy public proceeding, and the likely participation of interested parties, should it elect to propose to deaverage rates.

855. We therefore conclude that the common line cost recovery methods we have previously enacted, together with the price cap system we are proposing in this Notice, will not permit the kind of disparities in CCLC charges that would prompt interexchange carriers to deaverage their rates. Several commenters have argued that, if this is the conclusion we reach, then a prohibition on deaveraging would not affect the interexchange industry and ought to be adopted. Given that our actions in establishing and updating common line cost recovery mechanisms have demonstrated our commitment to preserving geographic rate averaging, and that the price cap plan we propose for LECs provides no banded pricing flexibility for the CCLC, we remain unconvinced that any further action on our part is warranted at this time. Although we believe that our proposed price cap system for LECs will not create incentives for AT&T to deaverage rates, our pledge to submit any such AT&T tariff to detailed public regulatory scrutiny, should allay any fears that price cap regulation would contribute to an unannounced and unchallenged movement to deaveraged rates.

E. Other Issues

1. Monitoring and Performance Review

a. Summary of Further Notice

856. In the Further Notice, we tentatively concluded that a performance review of our price cap regulatory system would be necessary to protect against any unanticipated and unintended effects stemming from the design of

our system or the construction of our formulas.[1751] We tentatively found, however, that carriers should first be given an opportunity to act on the incentives offered by price cap regulation. We therefore proposed to monitor the effects of price cap regulation during the initial four year period, and initiate a performance review after three years of price cap regulation.[1752]

b. Pleadings

857. Most parties commenting on the issue support our proposal to use existing mechanisms to monitor carrier performance during the initial period of price cap regulation.[1753] ICA also requests that ARMIS reports be made available to the general public.[1754] Ad Hoc favors the requirement of additional reports, and the Nevada PSC states that it has no confidence in this Commission's ability to monitor abuses.[1755] US West, Illinois, and NY EnerTel support a performance review after three years, although NY EnerTel, along with Alabama PSC, states that this Commission should be prepared for earlier review and adjustment, if necessary.[1756] Cable & Wireless contends that the promise of a performance review will result in continued Averch-Johnson effects, but that this Commission must review carrier performance in order to assure just and reasonable rates.[1757]

858. Parties state that this Commission should consider a variety of aspects of carrier performance, including price, quality of service, rate of return, costs, separations, and productivity.[1758] The Ohio PUC and

---

1751 3 FCC Rcd at 3446-47 (paras. 471-72).

1752 Id. at 3446-47 (para. 472).

1753 See NYNEX Comments at 38 n.44; Pactel Comments at 53; US West Comments at 16; CBT Comments at 4; Contel Comments at 30; United Comments at 24; ICA Comments at 20-21; Alabama PSC Comments at 5. However, ICA questions whether sufficient resources are available.

1754 ICA Comments at 20-21.

1755 Ad Hoc Comments at 19; Nevada PSC Comments at 3.

1756 US West Comments at 16; Illinois Comments at 29-30; NY EnerTel Reply at 4; Alabama PSC Comments at 5-6.

1757 Cable & Wireless Comments at 10. See also MCI Comments at 27 (review continues perverse incentives of current regulation).

1758 See United Comments at 21; USTA Comments at 54; Alabama PSC Comments at 5; Michigan PSC Comments at 26; New York DPS Comments at 30; Ohio PUC Comments at 4.

Ameritech suggest that this Commission should compare the performance of LECs under price cap regulation with the performance of those LECs that continue under rate of return regulation.[1759] The Colorado OCC and the Indiana UCC argue that this Commission should specify a rate of return that will act as a ceiling.[1760] However, BellSouth, United, Cable & Wireless, and Illinois argue that a rate of return trigger will damage the incentive structure established by price cap regulation.[1761]

859. Illinois argues that frequent adjustments to the price cap formulas would similarly affect incentives.[1762] Parties offer a variety of suggestions on the nature of adjustments that could be required. New York DPS argues that if returns are excessive, both the PCI and the productivity factor should be adjusted, while US West states that productivity factor adjustments may be required.[1763] Parties agree with our tentative decision not to require retroactive payments.[1764] The Ohio PUC suggests that this Commission require that earnings over a certain, preset level be shared between customers and carriers.[1765]

c. Discussion

860. The issues raised with respect to monitoring and review of LEC performance under price cap regulation are in most respects the same as the issues discussed earlier with regard to AT&T. We tentatively conclude that a similar framework of monitoring and performance review would be suitable for the LECs. We propose to monitor the LECs' performance, with particular attention to prices, earnings, quality of service, and technological progressiveness. ARMIS will provide us with a consistent set of data for the

---

1759 Ohio PUC Comments at 4; Ameritech Reply at 66.

1760 Colorado OCC Comments at 23-24; Indiana UCC Comments at 28.

1761 BellSouth Comments at 14; United Comments at 24; Cable & Wireless Comments at 10; Illinois Comments at 30.

1762 Illinois Comments at 31.

1763 New York DPS Comments at 30-31; US West Reply at 27.

1764 BellSouth Comments, App. at 2 (statement of A. Kahn); CCIA Comments at 5; Illinois Comments at 31; New York DPS Comments at 30; Pactel Reply at 19.

1765 Ohio PUC Comments at 9.

two years immediately preceding price cap regulation and for the initial years of price caps. The ARMIS reports will include information on revenues, expenses, investment, taxes, and earnings, as well as demand data. These reports will permit this Commission to monitor a variety of LEC activities, including cost allocations between regulated and nonregulated activities and allocations between the state and interstate jurisdictions.[1766] In addition, we propose to require LECs to file service quality reports, which will enable this Commission and other interested parties to monitor trends in quality of service.[1767]

861. In addition to monitoring price cap regulation through the collection of data, our review of tariffs, and complaints, we will review LECs' performance in a comprehensive manner after the inauguration of price cap regulation. The performance review will consider all available measures of market and carrier performance, including, but not limited to, actual prices, achieved rate of return, quality of service, and technological progressiveness. Of course, decisions about certain aspects of the timing and nature of the comprehensive review must await the resolution of outstanding issues associated with LEC productivity.[1768] Parties commenting on the nature of the performance review for the LECs should do so in the context of this Commission's proposals to address productivity issues.

2. Effect of Incentive Regulation on Existing Commission Policies

a. ONA

862. In the Further Notice, we tentatively decided that ONA and CEI protections against discrimination should remain in effect under price cap regulation.[1769] We also tentatively concluded that concerns as to discriminatory or anticompetitive pricing of ONA services can be addressed in the tariff review process. Finally, we noted that interested parties will be aware of revisions otherwise subject to streamlined regulation, because our rules require that carriers specifically note changes in Basic Service Elements in their transmittals as well as on actual tariff pages.[1770]

1766 See ARMIS Order.

1767 See Section IV.B.2, supra.

1768 See Section IV.C.1.c, supra.

1769 3 FCC Rcd at 3379 (para. 329).

1770 Id. at 3380 (para. 331).

863. The Ohio PUC and API support the retention of existing market rules, including the ONA and CEI requirements.[1771] However, Alarm Industry argues that there is a tension between price caps, which it terms "non-cost-based," and the regulatory structure of Computer III, which it calls "cost-based." Specifically, Alarm Industry contends that the bands will permit deviation from a "cost-based" price.[1772] Alarm Industry recommends that this Commission either exempt ONA services from price cap regulation, or as a less satisfactory alternative, control the prices of these services through the Computer III rules. Alarm Industry suggests that we delay the application of price cap regulation to ONA services until we have some experience with ONA.[1773] EDS also contends that Computer III requires cost-based pricing, and argues that this Commission must assure that price caps foster cost-based pricing. EDS states that it supports a proposal to defer or suspend ONA tariffs that appear discriminatory or anticompetitive, and also supports a requirement that carriers note BSE changes in their transmittals. EDS argues that this Commission should consider whether further safeguards are necessary.[1774] Finally, New Hampshire PUC contends that this Commission should stagger our schedules for the implementation of ONA and price caps in order to assess more accurately the impact of each proceeding.[1775]

864. We are unpersuaded by arguments that there are theoretical or practical barriers to implementing both price cap regulation and our ONA policies. The ONA Order requires federal tariffing of interstate ONA services, such as interstate Basic Service Elements and Basic Serving Arrangements, within the framework of Part 69 of our rules.[1776] This is consistent with our price cap proposal, pursuant to which all services subject

---

1771 Ohio PUC Comments at 17; API Comments at 27.

1772 Alarm Industry Comments at 2, 5.

1773 Id. at 3, 6.

1774 EDS Comments at 13-15.

1775 New Hampshire PUC Comments at 8.

1776 See Filing and Review of Open Network Architecture Plans, CC Docket No. 88-2, Phase I, Memorandum Opinion and Order, FCC 88-381, released Dec. 22, 1988 (hereinafter ONA Order) at paras. 271-282. In the ONA Order, we announced our intention to conduct a rulemaking on modifications needed in Part 69 of our rules to accommodate federal tariffing of ONA services. Id. at paras. 281-82. The ONA Order also proposed to examine whether some Computer III "pricing requirements" continue to be necessary. Id. at para. 281.

to price caps will be federally tariffed and subject to the rate structure requirements of Part 69.

865. Suggestions that price cap and ONA policies are inherently in conflict because only ONA services are "cost-based" are without foundation. The Communications Act requires all federally tariffed services to be provided at "just and reasonable" rates.[1777] Both the courts and this Commission interpret this requirement to mean that such rates must be related to the cost of providing services. Our ONA policies are in harmony with this requirement,[1778] and as we explain in detail elsewhere in this Order,[1779] the foundation of the price cap regulatory approach is to ensure that rates follow costs, while creating incentives to reduce costs, and the rates consumers pay for services, below what they likely would be if we continue to administer the current regulatory scheme. Indeed, in a very real sense, the goals of ONA are more compatible with price cap regulation than the existing scheme because unlike rate of return regulation, ONA and price cap policies are designed to promote incentives for innovation and efficiency. Commenters who disagree with this tentative conclusion are requested to explain in detail how these two policies will be in conflict.

866. The ONA Order contemplates that the federally tariffed Basic Service Elements and Basic Serving Arrangements will be available to all users, and that these services will consist of unbundled access elements that will be purchased by enhanced service providers as well as by other users of exchange access.[1780] We tentatively conclude that such ONA services do not differ from other interstate basic services offered by the BOCs in any way that is relevant for purposes of this proceeding. Accordingly, we do not propose to require further special treatment for ONA services as part of price cap regulation.[1781] As ONA and price cap regulation appear to be compatible, we tentatively decide that it is unnecessary to stagger the schedules for implementation of either proceeding. We will ensure that such implementation occurs in a coordinated fashion.

1777 See Section V, infra.

1778 See ONA Order at para. 165 n.326.

1779 See Sections III.C.1.e and IV.C.1.e, supra.

1780 Id. at para. 323 n.770.

1781 As discussed supra, Section IV.C.2.b, we do invite comment on whether unbundled services offered pursuant to separate Part 69 subelements, such as BSEs, equal access, and 800 access, should be subject to banding limitations.

b. Other Market Rules and Implementing Regulations

867. In the Further Notice, we stated that we intended to retain existing policies and rules that foster competition and prevent discrimination in the provision of telecommunications services.[1782] BellSouth, Ohio PUC, API, USTA, and Rochester support this Commission's tentative decision to retain existing market rules, including open entry, equal access, resale and shared use, interconnection, unbundling of tariffed services, and nonstructural safeguards, as well as the separations rules, the joint cost rules, and the USOA.[1783] The Arkansas PSC, however, contends that the Separations Manual, the USOA, and the joint cost rules were designed for rate of return regulation.[1784]

868. We adhere to our tentative conclusion that the implementation of price cap regulation for the LECs will be enhanced by the continuation of existing market rules, the USOA, the Separations Manual, and the joint cost rules. Furthermore, we tentatively decide that the implementation of price cap regulation for the LECs will not require the overhaul of the separations rules, the USOA, or the joint cost rules. While these rules were all initiated during a time when this Commission regulated the LECs by rate of return regulation, the rules would continue to serve an important and necessary role in price cap regulation. In fact, we tentatively conclude that the retention of these rules will help ensure that the implementation of price cap regulation at the federal level does not disrupt state regulatory systems, since the foundation for jurisdictional separations remains intact.

c. Complaint Procedures

869. In the Further Notice, we tentatively decided to retain our existing complaint procedures.[1785] Ameritech argues that price cap incentives will be lost if this Commission entertains complaints alleging that a rate yields an excessive rate of return. Ameritech requests that this Commission specify criteria for setting out a prima facie case, and suggests that in order to state a cause of action, a complainant should be required to show that one of the objectives of the access charge proceeding has been

---

1782 3 FCC Rcd at 3379 (para. 328).

1783 See BellSouth Comments at 60-61; Ohio PUC Comments at 17; API Comments at 27; USTA Comments at 7; Rochester Reply at 3.

1784 Arkansas PSC Comments at 2.

1785 3 FCC Rcd at 3380-81 (para. 332).

compromised.[1786] API contends that there are delays in the complaint process, and that this Commission should improve the efficacy of the process.[1787] IDCMA requests articulation of the standards and burdens of proof for a complaint.[1788]

870. We adhere to our tentative conclusion to retain existing complaint procedures. Prompt resolution of complaints will be assured by the recent adoption of legislation requiring the resolution of complaints within one year, or in certain cases, 15 months.[1789] Nothing in this proceeding affects the standards or burdens associated with the complaint process. To the extent that facts reside exclusively within the knowledge of the defendant carrier, the carrier has the burden of going forward with that evidence. Once the carrier-defendant has met its burden of proving the facts within its knowledge, the ultimate burden of persuasion must be carried by the complainant.[1790]

d. Part 63 Rules

871. We tentatively concluded in the Further Notice that continued enforcement of the Part 63 rules concerning extension of lines and discontinuance of service would be desirable under price cap regulation. Pactel states that it generally agrees with this Commission's tentative conclusion, but contends that this Commission should not use Part 63 to evaluate the prudence of new investment, and should waive these aspects of the rules for price cap carriers.[1791]

872. We adhere to our tentative decision to continue to enforce the Part 63 rules under price cap regulation. The Part 63 rules enable this Commission to monitor carrier network and service operations. There is no evidence that the current approach is burdensome, and as continued application of Part 63 will provide an additional means of safeguarding the public interest, we tentatively decide to retain these rules.

1786 Ameritech Comments at 41-42.

1787 API Comments at 28-29.

1788 IDCMA Comments at 51-52.

1789 See Federal Communications Commission Authorization Act of 1987, P.L. 100-594 (signed Nov. 3, 1988).

1790 See Section III.D.3, supra.

1791 Pactel Comments at 56-57.

V. LEGAL AUTHORITY

A. Summary of Further Notice

873. In the Further Notice, we tentatively concluded that the Communications Act does not require us to employ a rate of return methodology in carrying out our mandate to ensure just and reasonable rates.[1792] Rather, we found in the Act a congressional intent to accord this Commission broad discretion in selecting regulatory tools, so long as those tools are reasonably designed to produce rates that fall within a "zone of reasonableness."[1793] The Further Notice tentatively concluded that the price cap plan proposed for AT&T and the LECs -- which provided for initial caps based upon existing rates, an adjustment mechanism to account for cost changes, continued monitoring of carrier performance, and retention of investigation and complaint proceedings -- would operate to help keep rates within the zone of reasonableness, and to detect and correct deviations from that zone.[1794]

874. The Further Notice also tentatively determined that the proposal to implement price cap regulation as, in essence, a change in tariff filing and review procedures was consistent with this Commission's statutory authority under Sections 203 and 204 of the Communications Act, 47 U.S.C. §§ 203, 204.[1795] In reaching this tentative conclusion, we considered and rejected arguments, on the one hand, that we must prescribe rates to ensure that rates under price caps will be just and reasonable, and, on the other hand, that our plan constituted a de facto rate prescription in violation of the hearing requirements contained in Section 205 of the Communications Act, 47 U.S.C. § 205.[1796] Nevertheless, this Commission explicitly requested further comment regarding whether a valid rate prescription is a legal prerequisite to price cap regulation.[1797]

875. Finally, the Further Notice recognized that since the proposed price cap plan necessarily required some decisions of a judgmental and

---

1792 Further Notice, 3 FCC Rcd at 3296 (paras. 193-94). See also Notice, 2 FCC Rcd at 5211.

1793 Further Notice, 3 FCC Rcd at 3297 (para. 195).

1794 Id. at 3299 (para. 196).

1795 Id. at 3300 (para. 197).

1796 Id. at 3304-06 (paras. 204-06).

1797 Id. at 3305 (para. 205).

predictive nature, this Commission should proceed cautiously -- by making the plan voluntary, by retaining the regulatory machinery necessary to monitor carrier performance, and by proposing a comprehensive review of the plan after three years.[1798] At the same time, we tentatively determined that the proposed price cap plan would better serve our statutory objectives than traditional rate of return regulation has, and that the Communications Act and relevant judicial precedent empowered this Commission to adopt the proposed reforms.[1799]

B. Pleadings

876. In general, the parties' latest comments regarding the legality of price cap regulation are consistent with the views they expressed in earlier rounds of this proceeding.[1800] Most parties addressing the issue concur with this Commission's tentative conclusion that the Communications Act does not compel use of a rate of return methodology in regulating the rates of dominant carriers.[1801] However, commenters sharply disagree on whether the price cap alternative proposed in the Further Notice passes legal muster. Commenting dominant carriers assert that the proposed price cap plan, including the PCI adjustment mechanism, will ensure that rates fall within the statutory zone of reasonableness.[1802] However, many other commenters dispute this conclusion.[1803]

1798 Id. at 3306 (para. 207).

1799 Id.

1800 See id. at 3294-95 (paras. 190-93).

1801 Ameritech Comments at 2, 36-38; Ameritech Reply at 4-6; GTOC Comments at vi, 18; GTOC Reply at 14-16; NYNEX Comments at 9-11; Pactel Reply at 31; USTA Reply at 17; US West Comments at 19-20; Centel Comments at 4; Comsat Comments at 2; NTN Comments at 14. See also Ad Hoc Comments at 2 (agreeing that a properly designed price cap system could be implemented). But see AARP Comments at 40-41, and New Hampshire PUC Comments at 9-10, 13 (both contending that this Commission must retain rate of return regulation in the absence of congressional direction otherwise). See also CFA Comments at 10, and Maryland PC Comments at 11 (both asserting that the proposed price cap plan fails to ensure just and reasonable rates, because it pays insufficient attention to carrier profits).

1802 Ameritech Comments at 35-37; BellSouth Comments at 8-9; GTOC Comments at 14, 21; NYNEX Comments at 3; Pactel Reply at 33-34; USTA Reply at 13-14; US West Comments at 19; Centel Comments at 4.

1803 E.g., Ad Hoc Comments at 20; ICA Comments at 5-6; AARP Comments at 38-39, 43; CFA Comments at 9-10; Maryland PC Comments at 5-12; Michigan PSC

877. Price cap opponents criticize this Commission's proposal to initiate the new regulatory regime for AT&T based upon existing rates.[1804] Several of them argue that, even if the PCI formula accurately tracks productivity, inflation, and exogenous cost factors, the use of existing rates to establish initial caps would unlawfully divorce rates from costs, since many existing rates are not cost-based.[1805] These parties view the problems associated with existing rates as being particularly acute with respect to the LECs, who, by virtually all accounts, face less competition than AT&T, and whose rates have been subject to investigation and complaint for various alleged infirmities, including strategic pricing.[1806] Some contend that, in addition to allowing unlawfully high rates under price caps, the use of existing noncost-based rates could free carriers to maintain or expand discriminatory and anticompetitive rate structures.[1807] Some opponents add that the proposal to establish transitional procedures for adjusting cap levels to reflect the outcome of ongoing investigations is inadequate to remedy these alleged legal and practical shortcomings.[1808]

878. Most price cap supporters insist that basing initial price caps for AT&T and the LECs on existing rates is the most practical means of implementing the new regulatory program, and perfectly legal.[1809] They note

---

Comments at 4, 12; New Hampshire PUC Comments 11-12.

1804 See, e.g., NTN Comments at 10; ICA Comments at 5-6; IDCMA Comments at 42-43; IIA Comments at 5-6; Networks Comments at 11-12; TeleComm Comments at 11-13; Colorado OCC Comments at 14; DC PC Reply at 6; Maryland PC Comments at 5-9; Maryland PC Reply at 11; New Hampshire PUC Comments at 11; New York DPS Comments at 28; Wisconsin PSC Comments at 8.

1805 E.g., ICA Comments at 13-14; Maryland PC Comments at 4-5; Wisconsin PSC Comments at 8.

1806 See, e.g., MCI Comments at 7-19; Ad Hoc Comments at 7-8; ICA Comments at 13-14.

1807 E.g., NTN Comments at 10-11; Comptel Comments at 13, 16, 21-22, 26; AARP Comments at 5-11, 42.

1808 E.g., MCI Comments at 15 n.17. MCI's concerns in this regard are directed solely at the LECs, but the argument is not logically or factually restricted to the LECs.

1809 AT&T Reply at 30-32; GTOC Comments at 16-18; NYNEX Comments at 13-15; Pactel Reply at 4, 27; SWB Comments at 13; SWB Reply at 37, 39; US West Comments at 26-31; USTA Comments at 38; United Comments at 9-10.

that existing rates have already been subjected to the tariff review process, giving such rates a sufficient measure of reliability for the limited procedural purpose of establishing suspension and no-suspension zones.[1810] In addition, many of these parties contend that since price caps limit the importance of cost allocations among services, dominant carriers have neither the incentive, nor the ability, to engage in discriminatory or anticompetitive pricing, irrespective of any divergence from cost that might be embedded in existing rates.[1811] However, several price cap supporters express practical[1812] and, in at least one instance, legal[1813] misgivings regarding the proposal to use base period average rates, rather than a set of actual rates in effect at a given point in time, in establishing initial caps.

879. Related to the Further Notice's proposal to use existing rates in developing initial price caps, some commenters contend that this Commission must prescribe and tighten caps to ensure that rates will be just and reasonable.[1814] Several of these parties argue that use of suspension and no-suspension zones as substitutes for a rate prescription is unlawful in the absence of an express finding that competition will constrain carriers to offer non-exploitative rates.[1815] At the same time, some of these commenters claim that this Commission's proposal to create price caps based

---

1810 Id.

1811 See, e.g., GTOC Comments at 41; NYNEX Comments at 20; SWB Comments at 23; CCIA Comments at 3. Cf. AT&T Reply at 85-88 (asserting that because of their monopoly positions as access service providers, LECs may be able to engage in strategic and discriminatory pricing unless the number of baskets is increased to prevent cross-subsidies within baskets).

1812 See Sections III.C.3.a.ii, and III.C.3.d.ii, supra.

1813 AT&T Comments at 35-37 (questioning legality and reasonableness of using average rather than actual rates as a means of setting initial caps, since average base year rates may not bear a reasonable relationship to carrier costs at the outset of price cap regulation). See also US West Comments at 26-27 (expressing concern regarding use of average rates to establish initial caps, but concluding that the proposal is lawful, since participation is voluntary and the caps are used only for tariff review purposes).

1814 E.g., Ad Hoc Comments at 41-54; AARP Comments at 34-38; CFA Reply at 5 n.1.

1815 Ad Hoc Comments at 46; ICA Reply at 6; CFA Comments at 10; Maryland PC Comments at 9. Contra NYNEX Reply at 8-9; Pactel Reply at 32-33; US West Reply at 6-8.

upon existing rates, combined with the establishment of suspension and no-suspension zones, constitutes an unlawful de facto rate prescription without the hearing required by Section 205 of the Communications Act, 47 U.S.C. § 205.[1816] On the other hand, a number of commenters, including AT&T and the LECs, state that we need not and have not proposed a rate prescription.[1817] Rather, they assert that in general our price cap proposal is consistent with the statutory design of carrier initiated rates, and will ensure that rates fall within the required zone of reasonableness.[1818]

1816 Ad Hoc Comments at 41-46; AARP Comments at 34. Cf. US West Comments at 26-27 (asserting that proposal to establish caps based upon base year average rates is not a prescription, but only because participation in the program is voluntary); BellSouth Reply at 9-12, and GTOC Reply at 6 (both suggesting that the plan might be a de facto prescription if mandatory).

1817 E.g., AT&T Reply at 28-32; Ameritech Reply at 47-49; GTOC Reply at 7-11; NYNEX Reply at 5-10; Pactel Reply at 27-29; SWB Reply at 2-3, 37-39; US West Reply at 4-6, 10.

1818 E.g., Ameritech Comments at 35-37; BellSouth Comments at 8-9; GTOC Comments at 14, 21; NYNEX Comments at 3; Pactel Reply at 33-34; USTA Reply at 13-14.

C. Discussion

1. In General

880. In adopting a modified price cap plan for AT&T and seeking further comment on price caps for LECs, this Commission has addressed many of the concerns expressed in the pleadings. We continue to believe that our price cap plan, as modified for AT&T, is within our statutory authority.[1819] We conclude, based upon the administrative record established in this proceeding, that adoption of the price cap rules for AT&T that accompany this Report and Order is in the public interest, as defined in the Communications Act and relevant judicial precedent. We also tentatively conclude that with an adequately developed record, this Commission has authority to adopt the amended price cap plan for LECs that we propose, and seek comment on, in this Report and Order and Further Notice.

2. AT&T Plan

881. The Communications Act requires telecommunications common carriers to charge just, reasonable, and non-discriminatory rates for their interstate services,[1820] and requires this Commission to "execute and enforce [the Act's] provisions."[1821] As we concluded in the Further Notice, however, the statute does not compel us to employ rate of return regulation, or any other particular regulatory model, in carrying out our statutory mandate.[1822]

1819 See Further Notice, 3 FCC Rcd at 3296-3306.

1820 47 U.S.C. §§ 201, 202.

1821 47 U.S.C. § 151.

1822 In both the Notice and the Further Notice we examined the legislative history of the Communications Act of 1934, and determined that in enacting the statute, Congress did not intend to compel a rate of return methodology. See Notice, 2 FCC Rcd at 5211 n.49; Further Notice, 3 FCC Rcd at 3296 n.346. As the Supreme Court has stated in connection with an analogous statute: "Congress, however, has provided no formula by which the 'just and reasonable' rate is to be determined.... It has not expressed in a specific rule the fixed principle of 'just and reasonable.'" FPC v. Hope Natural Gas, 320 U.S. 591, 600-01 (1944). Accord Duquesne Light Co. v. Barasch, No. 87-1160, slip op. at 15-16 (U.S. Jan. 11, 1989). None of the pleadings regarding the Further Notice cite any statutory or legislative authority that refutes our earlier analysis. Indeed, even the ex parte filing of the Majority Staff of the House Subcommittee on Telecommunications and Finance, while criticizing the plan proposed in the Further Notice as insufficiently cost-based, and therefore unlawful, does not appear to challenge this Commission's legal authority to depart from traditional rate of return regulation. See

Indeed, the Supreme Court this year reaffirmed that "'no single method need be followed by the Commission in considering the justness and reasonableness of rates.'"[1823] In doing so, the Court found that "circumstances may favor the use of one rate making procedure over another."[1824] It concluded that "[t]he designation of a single theory of rate making ... would unnecessarily foreclose alternatives which could benefit both consumers and investors."[1825]

882. Rather than seeking to foreclose regulatory alternatives, Congress provided this Commission "broad discretion" in "'selecting methods ... to make and oversee rates ....'"[1826] In reviewing ratemaking procedures under the Communications Act and under cognate statutes requiring just and reasonable rates, courts examine the end results of the regulatory schemes to determine whether they produce rates that fall within a "zone of reasonableness."[1827] Although costs generally provide an important benchmark by which to evaluate rates,[1828] the zone of reasonableness is not defined by a "'rigidly ... cost-based determination of rates, much less ... one that bases each [carrier's] rates on his own costs.'"[1829] Rates falling within

---

Subcommittee Staff Analysis at 25 n.78.

1823 Duquesne Light Co. v. Barasch, slip op. at 16 (quoting FPC v. Texaco, 417 U.S. 380, 387-90 (1974)).

1824 Duquesne Light Co. v. Barasch, slip op. at 16.

1825 Id.

1826 MCI Telecommunications v. FCC, 675 F.2d 408, 413 (D.C. Cir. 1982)(quoting Aeronautical Radio v. FCC, 642 F.2d 1221, 1228 (D.C. Cir. 1980), cert. denied, 451 U.S. 920 (1981)). See Further Notice, 3 FCC Rcd at 3297 (para. 194).

1827 See, e.g., FERC v. Pennzoil Producing, 439 U.S.508, 517 (1979); AT&T v. ICC, 836 F.2d 1386, 1390 (D.C. Cir. 1988)(quoting Jersey Cent. Power & Light v. FERC, 810 F.2d 1168, 1177 (D.C. Cir. 1987)). See also FPC v. Hope Natural Gas, 320 U.S. at 602 ("Under the statutory standard of 'just and reasonable' it is the result reached and not the method employed that is controlling."). Accord Duquesne Light Co. v. Barasch, slip op. at 10 (citations omitted)("Today we reaffirm these teachings of Hope Natural Gas: '[I]t is not theory but the impact of the rate order which counts.'").

1828 Farmers Union Cent. Exch. v. FERC, 734 F.2d 1486, 1502 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984). See generally MCI Telecommunications v. FCC, 675 F.2d at 410.

1829 FERC v. Pennzoil Producing, 439 U.S. at 517 (citation omitted); see also Permian Basin Area Rate Cases, 390 U.S. 747, 769, 797-98, 800-05, reh'g

the zone must simply be the product of a "reasonable balancing" between the "investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates."[1830] We reaffirm our conclusion contained in the Further Notice that "ultimately, the substantive mandate under which we operate requires only that we select a ratemaking approach that is capable of keeping rates in the zone of reasonableness, or of detecting and correcting for the failure of market forces to do so."[1831]

883. The price cap plan for AT&T delineated in this Report and Order fulfills the Communications Act's substantive requirement of ensuring just, reasonable, and non-discriminatory rates. And it does so in a cautious, evolutionary manner. As described in Section III.C.3.d, supra, the plan uses AT&T's existing rates developed under rate of return regulation as the point of departure for establishing initial caps.[1832] While in most cases these rates have not affirmatively been found to be just, reasonable, and non-discriminatory, we believe they represent an equitable and lawful point from which to launch the price cap system adopted herein. First, recent AT&T earnings reports indicate that in the aggregate AT&T has not been earning in excess of its allowable rate of return for either the public switched or private line categories.[1833] Second, all of AT&T's rates have been subject to tariff review under traditional procedures and have been allowed to take

---

denied, Bass v. FPC, 392 U.S. 917 (1968)(upholding ratemaking based upon area-wide average costs); Farmers Union Cent. Exch. v. FERC, 734 F.2d at 1502-03(acknowledging agency authority to consider non-cost factors in establishing just and reasonable rates).

1830 Jersey Cent. Power & Light v. FERC, 810 F.2d at 1177-78. See also AT&T Information Systems v. FCC, No. 85-1198, slip op. at 3 (D.C. Cir. Aug. 30, 1988)(for rates to be just and reasonable "there must be 'a balancing of the investor and the consumer interests ...'").

1831 Further Notice, 3 FCC Rcd at 3298 (para. 195)(citing Farmers Union Cent. Exch. v. FERC, 734 F.2d at 1509).

1832 Since we have determined to employ AT&T's actual rates as of the end of the pre-price cap base period, rather than its base period average rates, as the point of departure for price caps, we need not decide whether the use of average rates for that purpose would raise legal concerns. See, e.g., AT&T Comments at 35-37.

1833 See Form 492 for AT&T, filed December 30, 1988. See Section III.C.3.d.i, supra.

effect. Third, nearly all of AT&T's existing rates have been subject to, and have survived, recent investigations.[1834]

884. This Commission's cautious approach is also reflected in our decision to place AT&T's services into three carefully defined baskets, each subject to separate caps. As detailed in Section III.C.2.b, supra, this structural design provides additional protection against the risks, perceived by some, that AT&T might use within-basket cross-subsidies to finance anticompetitive or discriminatory prices. Moreover, on a prospective basis, the plan's PCI adjustment formula is designed to reflect, for each basket of services, changes in both individual firm costs, and economy-wide and industry-wide costs.[1835] The plan also provides for continued monitoring of AT&T's cost and profit data, and, after three years, for a comprehensive review of AT&T's performance, which will include evaluation of the relationship between rates and costs. Finally, the price cap plan retains tariff investigation and complaint proceedings under Sections 204 and 208 of the Communications Act, 47 U.S.C. §§ 204 and 208, which will continue to involve scrutiny of the nexus between AT&T's rates and its costs and profits.[1836]

885. We thus reject the assertion made by some commenters that our price cap plan fails to ensure just and reasonable rates because it pays insufficient attention to carrier costs and earnings.[1837] We have recognized

---

1834 See Section III.C.3.d.i, supra. To the extent that any existing rates that are currently subject to investigation are ultimately found unlawful, the price cap plan provides for appropriate corrective adjustments to the price and cost indexes. See Section III.C.3.b, supra.

1835 The PCI's firm-specific cost adjustments for changes in access costs and for specified regulation-induced cost changes are not different in principle from the treatment accorded those cost changes under rate of return regulation, except that the process of calculating those changes in the PCI is simplified by the use of historical weights rather than future demand projections. The adjustments for economy-wide and industry-wide cost changes reflected in the PCI's (GNP-PI - X) variable are similar in principle to the current treatment accorded average schedule companies under rate of return regulation, and is also analogous to the Federal Power Commission's use of area-wide average natural gas producer costs in ratemaking, which the Supreme Court upheld in Permian Basin Area Rate Cases, 390 U.S. at 769, 797-98, 800-05.

1836 As explained in Section III.D, supra, the price cap plan for AT&T also leaves undisturbed the current USOA, joint cost, and separations rules.

1837 See, e.g., CFA Comments at 10; Maryland PC Comments at 11.

from the outset of this rulemaking that an acceptable price cap approach cannot free carriers to earn excessive profits in light of their costs,[1838] and the program we are adopting does not do so. Both the ongoing monitoring and the comprehensive review contemplated in the price cap plan will focus prominently on carrier costs and profits; and to the extent that AT&T is able to improve productivity faster than anticipated, we stand poised to make prospective adjustments to the PCI formula to ensure that consumers share in that productivity improvement. During the interim, the use of rate of return generated existing rates to establish AT&T's initial price caps, and the subsequent price cap adjustments made pursuant to the PCI formula should keep AT&T's profit levels in check, even though the PCI formula is not explicitly tied to profits. And, as noted above, the complaint and investigation processes will also serve as a check on excessive profits.

886. Notwithstanding that our price cap system continues to monitor and consider profit levels to ensure they are not excessive in light of costs, it is also a system designed to permit greater earnings flexibility than a strict rate of return regime.[1839] This design is based upon the fundamental premise underlying incentive regulation and the benefits it will produce for ratepayers -- that it is the potential to increase earnings that drives companies to improve their efficiency.[1840] Stated another way, we believe

---

1838 See Notice, 2 FCC Rcd at 5214.

1839 As with ratemaking generally, as long as rates within the zone of reasonableness result, this Commission has broad discretion regarding the manner in which it deals with carrier profits. See generally Nader v. FCC, 520 F.2d 182 (D.C. Cir. 1975)(upholding Commission's decision to initiate a system of prescribing carrier rates of return); see also MCI Telecommunications v. FCC, 675 F.2d at 416 (upholding this Commission's adoption of an Interim Cost Allocation Manual for AT&T, under which AT&T would not necessarily be compelled to earn the same rate of return for each service). In addition, we observe that any ratemaking methodology that utilizes costs that are not firm-specific necessarily allows carriers to improve profits by reducing their costs below the benchmark set by the regulator. Such a result is implicit in the area-wide ratemaking scheme upheld in Permian Basin Area Rate Cases, 390 U.S. 747, as well as the rate-making methodology this Commission currently uses with respect to average schedule companies. See City of Brookings Mun. Tel. v. FCC, 822 F.2d 1153 (D.C. Cir. 1987); NARUC v. FCC, 737 F.2d 1095, 1127-29 (D.C. Cir. 1984), cert. denied, 469 U.S. 1227 (1985).

1840 Our attempt to harness this incentive in a manner that advances the public interest is not novel. In addition to the reform programs underway in various states and in Britain (see Section II.B, supra), other federal agencies have premised ratemaking procedures on the assumption that carriers will attempt to improve efficiency if given the opportunity to benefit from

that rates resulting in somewhat higher profits may remain just and reasonable in the context of a regulatory regime that encourages carriers to become more efficient and to lower costs, with consumer benefits assured in the form of lower rates that would not otherwise have been achieved. We believe this approach to rate regulation is fully consistent with our statutory mandate to ensure just and reasonable rates.[1841]

887. We realize that any regulatory reform not only must ensure just, reasonable, and non-discriminatory rates, but also must "recognize the careful accommodation of interests" reflected in the Communications Act's "procedures and limitations concerning the ... processing of carrier initiated rates."[1842] The regulatory regime we are adopting for AT&T fits comfortably within the Act's procedural requirements. As explained in greater detail

---

such improvement. See, e.g., Associated Gas Distributors v. FERC, 824 F.2d 981, 1007 (D.C. Cir. 1987), cert. denied, 108 S.Ct. 1468, 1469 (1988)(upholding generally FERC authority to establish a system of open access and flexible rates for natural gas pipeline transportation in order to "impos[e] on pipelines more of the risk and responsibility for their own business decisions ...."); Domestic Passenger-Fare Investigation, Phase 4 - Joint Fares, Order Serial No. 72-4-42 (Apr. 10, 1972), CCH Aviation Law Reports § 22,062.05 at 14,101 (CAB decision basing the use of average industry costs in distributing revenues from joint airline fares, on the efficiency incentives such a practice would create among airlines).

1841 See Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974), in which the Supreme Court upheld a Federal Power Commission incentive plan that permitted an increase in rates in order to encourage increased production. In doing so, the Court emphasized that it was permissible for the agency to consider non-cost factors:

> Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional "non-cost" incentives on the evidence of a need for increased supplies.

Id. at 316. See also Public Service Comm'n of New York v. FERC, 589 F.2d 542, 559 (D.C. Cir. 1978)(stating that agencies have authority to adopt incentive based regulatory approaches in order to serve the public interest).

1842 AT&T v. FCC, 487 F.2d 865, 873 (2d Cir. 1973). See also Further Notice, 3 FCC Rcd at 3299-3300.

in Section III.C.4, supra, we are implementing price caps through the establishment of suspension and no-suspension zones and through modifications to our current tariff filing procedures. We have ample authority to adopt these changes under our Section 204[1843] suspension powers and our Section 203[1219] power to amend tariff filing requirements.

888. A decision by this Commission to permit a tariff to take effect without suspension "is not an adjudication as to the lawfulness of tariff rates, but rather constitutes an exercise of the FCC's discretionary authority under Section 204(a) of the Communications Act ...."[1844] As such, "[t]hat exercise constitutes a preliminary decision within the Commission's exclusive discretion."[1845] Pursuant to this discretionary suspension power, we may establish guidelines expressing "a tentative opinion about the location of the line between the just and the unjust, the reasonable and the unreasonable."[1846] Thus, courts have lauded as "an intelligent and practical exercise of [their] suspension power ...." agency proposals to create suspension and no-suspension zones similar to those we are adopting here.[1847]

1843 47 U.S.C. § 204.

1219 47 U.S.C. § 203. This Commission has broad authority under Section 203(b)(2) to adopt and modify procedural rules regarding the filing of tariffs. AT&T v. FCC, 503 F.2d 612, 613-14 (2d Cir. 1974). Even in the absence of rules changes, courts have upheld our power to waive procedural rules specifying the data that must be submitted in support of a tariff. See Aeronautical Radio v. FCC, 642 F.2d at 1235. In the Competitive Carrier proceeding, we employed our Section 203 authority to adopt rules permitting non-dominant carriers to file tariffs under streamlined procedures similar to those we are adopting here. See Competitive Carrier, First Report and Order, 85 FCC 2d 1 (1980).

1844 American Broadcasting v. FCC, 682 F.2d 25, 30 (2d Cir. 1982).

1845 Id. (citations omitted). See also Maine Public Advocate v. FCC, 828 F.2d 68, 69 (1st Cir. 1987); Aeronautical Radio v. FCC, 642 F.2d at 1234-35; Papago Tribal Util. Auth. v. FERC, 628 F.2d 235, 239-40 (D.C. Cir.), cert. denied, 449 U.S. 1061 (1980). Cf. Southern Ry. v. Seaboard Milling, 442 U.S. 444, 458-59, reh'g denied, 444 U.S. 890 (1979)(ICC decision not to investigate rate increase held unreviewable).

1846 Trans Alaska Pipeline Rate Cases, 436 U.S. 631, 653 (1978).

1847 Id.; see also Advanced Micro Devices v. CAB, 742 F.2d 1520, 1531 (D.C. Cir. 1984)(Advanced Micro Devices).

889. As we did in the Further Notice, we find particular support for our price cap approach in the District of Columbia Circuit's 1984 Advanced Micro Devices decision, which upheld Civil Aeronautics Board (CAB) tariff filing and review procedures akin to those we are adopting. Similar to our suspension policy for AT&T's interstate telecommunications services, the CAB in Advanced Micro Devices created a no-suspension zone for international cargo tariff filings.[1848] Also like our price cap plan, the CAB rules eliminated the requirement that carriers file cost data to justify rates within the zone, and placed upon rate opponents the burden of demonstrating "extraordinary circumstances" for suspending within-zone filings.[1849] The court determined that these rules were reasonable, and consistent with the CAB's statutory obligation to ensure just, reasonable, non-discriminatory rates.[1850]

890. Several commenters attempt to distinguish the CAB's no-suspension zone in Advanced Micro Devices from our price cap plan by claiming that the former was predicated upon express findings by Congress and the agency that competition would assist in keeping within-zone rates just and reasonable.[1851] They assert that in the absence of such a finding, we are without authority to establish a no-suspension zone for telecommunications tariffs.[1852]

891. We reject these contentions. While it is true that Congress and the CAB had found increasing competition in the international air cargo market,[1853] the D.C. Circuit did not rely exclusively upon that finding in considering the agency's authority to establish a no-suspension zone. Rather,

---

1848 742 F.2d at 1533.

1849 Id. at 1533-36. In fact, the court found the CAB's "extraordinary circumstances" test to be "very similar to the standard for preliminary relief in ... Virginia Petroleum Jobbers Ass'n v. FPC, 259 F.2d 921, 925 (D.C. Cir. 1958)," a standard upon which our own rules are based. Id. at 1533 n.7.

1850 Id. at 1531-37. The court stressed that the CAB (like this Commission under our price cap rules) retained the power to investigate and, where appropriate, to suspend within-zone rates, upon its own motion or that of a rate oppponent. Id. at 1532. The court also concluded that the agency reasonably "determined that it could accomplish its regulatory duties more efficiently by requiring cost data [from carriers] only when [within-zone] rates are challenged." Id. at 1536.

1851 Ad Hoc Comments at 46. See also CFA Comments at 10; Maryland PC Comments at 9.

1852 See, e.g., Ad Hoc Comments at 46.

1853 Advanced Micro Devices, 742 F.2d at 1523-24.

the court determined generally that "there is value in an agency articulating some suspension policy upon which the regulated industry can rely,"[1854] and stressed that since suspension decisions are not final adjudications on the merits of a rate, the creation of no-suspension zones should be subject to limited reviewability under the "arbitrary and capricious" standard.[1855] Applying the arbitrary and capricious standard to the circumstances of that case -- in which competition was but one of "[a] variety of factors" considered -- the court upheld the CAB action as a "rational" exercise of the agency's suspension powers.[1856]

892. It is clear that under the court's holding in Advanced Micro Devices, the presence or absence of competition may be relevant to whether a no-suspension zone, as designed, is arbitrary and capricious, but competition is not the foundation upon which agency authority to establish such a zone is necessarily built. In this regard, we have designed the AT&T price cap plan, including the no-suspension zone, to complement and take account of competition, where it exists.[1857] However, while we believe that the presence of competition adds to the reasonableness of the particular form of no-suspension zone we adopt for AT&T, we do not rely upon it as a necessary predicate. Rather, the PCI formula, banding rules, and baskets are all carefully crafted to ensure that rates remain tied to costs, and that consumers and competition are protected.

893. We reaffirm the tentative conclusion in the Further Notice that this Commission need not prescribe rates in order to adopt price caps.[1858] Courts have stressed that "[t]he choice of prescription vel non is entirely one for the agency, not the courts,"[1859] and, as in Advanced Micro Devices,

---

1854 Id. at 1531.

1855 Id. at 1528-29.

1856 Id. at 1530-31.

1857 We note that the record in this proceeding provides substantial evidence that at least some of AT&T's services are subject to increasing competition. See Section III.A.1, supra. Where this is the case, as in Advanced Micro Devices, competition will provide added assurance that rates are driven into the zone of reasonableness.

1858 See Further Notice, 3 FCC Rcd at 3304-05 (para. 204).

1859 Nat'l Ass'n of Motor Bus Owners v. FCC, 460 F.2d 561, 565 (2d Cir. 1972).

courts have upheld the establishment of no-suspension zones without rate prescriptions.[1860] We continue to believe prescribing rates is

---

1860 It is true, as Ad Hoc notes (Comments at 45), that the Federal Aviation Act provisions at issue in Advanced Micro Devices did not grant the CAB authority to prescribe international air cargo rates. The agency could reject or suspend such rates, but not prescribe them. 742 F.2d at 1523 n.1 (citing 49 U.S.C. § 1482(j)). However, contrary to Ad Hoc's assertions, this fact was irrelevant to the court's decision upholding the CAB action. The D.C. Circuit cited as precedent for its decision an earlier case, Nader v. CAB, 657 F.2d 453 (D.C. Cir. 1981). That case upheld CAB rules that expanded a no-suspension zone for domestic passenger fares, which, with certain exceptions specified in the Deregulation Act of 1978, were subject to prescription. Responding to claims that the passenger fare provisions in Nader were distinguishable from Federal Aviation Act's international cargo provisions, the Advanced Micro Devices court explained:

> These differences in no way detract from Nader's fundamental point, which is that under the Federal Aviation Act and without regard to the Deregulation Act the Board can establish a policy of limited suspension. Although the Board's suspension powers with respect to international cargo derive from a different subsection [from that governing passenger fares], ... Congress intended the powers to be virtually equivalent ... (principal differences are that [the] Board can suspend foreign rates but cannot prescribe them ...). We conclude, therefore, that Nader affirms the Board's statutory authority to develop a suspension policy.

742 F.2d at 1529. This analysis within the body of the Advanced Micro Devices opinion repudiates Ad Hoc's assertion that the absence of CAB prescription authority undermines that case's precedential value with regard to our price cap plan. Fundamentally, the CAB operated under the same mandate that we must follow -- preventing "unjust, unreasonable, [or] unjustly discriminatory" rates. 742 F.2d at 1523.

unnecessary, and that following our no-suspension/suspension zone proposal for AT&T will best serve the public interest.[1861]

894. We also reject claims that our price cap rules constitute a de facto rate prescription without the required hearing.[1862] It is neither the intent nor the effect of this decision to prescribe rates. While there exist general judicial statements to the effect that the existence of a prescription "must be determined by looking at the practical consequences of [the agency's] actions,"[1863] courts have never found procedures of the type we are adopting to be de facto prescriptions.

1861 See Further Notice, 3 FCC Rcd at 3304-05 (para. 204). See also Section III.C.3.d.i, supra.

1862 E.g., Ad Hoc Comments at 42, 46; AARP Comments at 34.

1863 Nader v. FCC, 520 F.2d at 199 (citation omitted). See also AT&T v. FCC, 487 F.2d at 874 (whether agency has prescribed rates depends upon impact of action rather than form).

895. The essence of a rate prescription is a finding that certain rates are "just and reasonable,"[1864] or that nonconforming rates are "unlawful and shall not occur."[1865] In practice, courts have found unlawful de facto prescriptions only where agencies made virtually explicit attempts to find particular rates just and reasonable -- or to prohibit particular rates as being unlawful -- without the required hearing.[1866] By contrast, our price cap rules neither establish the lawfulness of within-cap rates, nor prohibit the filing of nonconforming tariffs. Rather, our plan permits AT&T to file any rates it chooses, recognizing that the caps and bands constitute this Commission's "tentative opinion" about the dividing line between reasonable and unreasonable rates for the limited purpose of exercising our suspension power.[1867] The price cap plan only affects the procedural treatment of

---

1864 Nader v. FCC, 520 F.2d at 204.

1865 New England Tel. & Tel. v. FCC, 826 F.2d 1101, 1106 (D.C. Cir. 1987), reh'g and reh'g en banc denied (Nov. 2, 1988)(emphasis in original).

1866 In Moss v. CAB, 430 F.2d 891, 896 (D.C. Cir. 1970), for example, the court struck down a CAB fare formula for domestic airlines where "[t]he Board itself stated that it 'intend[ed] to consider fares produced by [its] formula as a 'just and reasonable' ceiling." Similarly, in AT&T v. FCC, 487 F.2d at 874-75, the court struck down this Commission's order, issued without hearing, that prohibited carriers from filing new rates without receiving special permission in advance. This requirement had the necessary consequence of holding new rates to be unlawful, and finding existing rates to be just and reasonable. Id. In examining these two cases, as well as the majority of other cases in which no de facto prescriptions were found, the D.C. Circuit has concluded that "[i]n practice, an agency statement has not been found to be a prescription absent explicit language that nonconforming tariffs will be rejected, combined with an agency motive to avoid public scrutiny and perhaps even judicial review." Direct Marketing Ass'n v. FCC, 772 F.2d 966, 971 (D.C. Cir. 1985). See Further Notice, 3 FCC Rcd at 3305-06 n.388.

1867 Trans Alaska Pipeline Rate Cases, 437 U.S. at 653. Even an agency's unqualified statement that nonconforming tariffs "would be suspended and investigated," coupled with a statement of its "general intention not to suspend conforming tariff sheets," will not convert a valid suspension policy into an unlawful de facto prescription so long as the agency action leaves the regulated entities with "an ability to choose among alternatives." See Consolidated Edison v. FPC, 512 F.2d 1332, 1340-41 (D.C. Cir. 1975). Our price cap plan does not take away AT&T's ability to choose to file above-cap rates. Compare id. at 1341 n.46 ("In Moss, therefore, the airlines' discretion was so circumscribed as to be almost nonexistent. The situation was not such that the airlines in fact had an option to choose between alternatives."). Moreover, below-cap rates filed by AT&T will remain subject to the complaint process, and, in some instances, may undergo investigation in

various carrier-initiated tariff filings, i.e., whether they are presumptively suspended or not, and does not determine whether particular rates are just, reasonable, and non-discriminatory.[1868] Far from being an unlawful de facto rate prescription, these rules reflect "an intelligent and practical exercise of [our] suspension power which is thoroughly in accord with Congress' goal ... to strike a fair balance between the needs of the public and the needs of regulated carriers."[1869] Because we are not prescribing rates, either explicitly or implicitly, we need not follow the procedural requirements of Section 205(a) of the Communications Act, 47 U.S.C. § 205(a), including the requirement that we provide "full opportunity for hearing."[1870]

3. Proposed LEC Price Cap Plan

896. In the Further Notice, this Commission detailed a price cap plan that included the LECs, and tentatively concluded that such a plan would be lawful.[1871] In this Report and Order and Further Notice we have proposed a modified "hybrid" approach to price caps for LECs, which is somewhat different from our approach for AT&T.[1872] Nevertheless, for many of the reasons set forth above, we tentatively conclude that our approach for the LECs is also lawful. We seek comment on this tentative conclusion.

---

the tariff review process.

1868 See Further Notice, 3 FCC Rcd at 3306 (para. 206).

1869 Trans Alaska Pipeline Rates Cases, 436 U.S. at 653.

1870 AT&T v. FCC, 487 F.2d at 874. The "hearing" described in Section 205(a) need not in all cases be an evidentiary or trial-type proceeding. AT&T v. FCC, 572 F.2d 17, 22 (2d Cir.), cert. denied, 439 U.S. 875 (1978). Depending upon "'the requirements of the particular case,'" notice and comment procedures may suffice. Id. (citations omitted). Accord NARUC v FCC, 737 F.2d 1095, 1120-21 (D.C. Cir. 1984).

1871 See generally Further Notice, 3 FCC Rcd at 3294-3306 (paras. 189-207).

1872 See Section IV, supra.

VI. PAPERWORK REDUCTION ACT ANALYSIS

897. On June 14, 1988, after the release of the Further Notice in this proceeding, this Commission requested that the Office of Management and Budget (OMB) review the proposed information collection requirements for compliance with the Paperwork Reduction Act. On August 15, 1988, OMB commented on this Commission's proposed information collection requirements.[1873] OMB stated that the Further Notice failed to demonstrate the practical utility of some of the reporting requirements proposed in the Commission's request, and found that the information collections are not the minimum necessary to meet the objectives of the proposed rule. In commenting on this Commission's request, OMB listed a series of concerns that it asked this Commission to address. Those concerns have been addressed in the context of this Commission's Final Order adopting and implementing price cap regulation for AT&T, and in the context of this Commission's Second Further Notice of Proposed Rulemaking proposing to implement price cap regulation for the LECs.

898. With respect to AT&T, discussion of the eight issues raised by OMB can be found at the following locations in the text of this Order: (1) need for a rate "floor" designating the bottom of the no-suspension zone -- pages 179 through 195; (2) need to band rates by rate element -- pages 179 through 195; (3) need for a 90-day review period for above-band rates -- pages 231 through 235; (4) need for identical tariff treatment of AT&T and LEC filings --pages 179 through 195, 221 through 257, 363 through 368, and 379 through 396;(5) burdens of expanding service quality reporting from Tier 1 LECs to all price cap carriers -- pages 79 through 85; (6) election of price caps by LECs -- not an issue affecting AT&T; (7) quantification of administrative savings and identification of changes in reporting requirements -- pages 53, 79 through 85, 92 through 93, 221 through 257, 264 through 265, and 266 through 271; and (8) impact on state regulators -- pages 79 through 85 and 89 through 91. AT&T is currently the only carrier subject to price cap regulation. Therefore, the price cap information collection requirements contained in this Order are not subject to the requirements of Section 3507 of the Paperwork Reduction Act of 1980, as amended (44 U.S.C.§ 3507).

899. Although this Order adopts incentive regulation for the LECs, we are not at this time promulgating final rules to implement incentive regulation for the LECs. This Order does, however, propose a set of regulations for implementing incentive regulation for the LECs. In connection with this Second Further Notice of Proposed Rulemaking with respect to the LECs, we renew our request for review of Paperwork Reduction Act requirements in light of the proposals made in this Further Notice. The proposed rules for LECs contained herein have been analyzed with respect to the Paperwork

---

1873 Letter from Franklin S. Reeder, Chief, Information Policy Branch, OMB, to Managing Director, FCC, Aug. 15, 1988.

Reduction Act of 1980 and found to decrease the information collection burden on the public. This proposed reduction in the information collection burden is subject to approval by OMB as prescribed by the Paperwork Reduction Act.

900. As we did in the case of adopting final rules for AT&T, we identify those portions of this Further Notice that respond to the eight OMB concerns raised in response to our Further Notice. With respect to the LECs, our response to OMB's concerns can be found at: (1) need for a rate "floor" designating the bottom of the no-suspension zone -- pages 363 through 368; (2) need to band rates by rate element -- pages 363 through 368; (3) need for 90-day review period for above-band rates -- pages 383 through 384; (4) need for identical tariff treatment of AT&T and LEC filings -- pages 179 through 195, 221 through 257, 363 through 368; and 379 through 396;(5) burdens of expanding service quality reporting from Tier 1 LECs to all price cap carriers --pages 288 through 291; (6) election of price caps by LECs --pages 303 through 308; (7) quantification of administrative savings and identification of changes in reporting requirements -- pages 53, 288 through 291, 379 through 396, 396 through 405, and 410 through 417;[1874] and (8) impact on state regulators -- pages 288 through 291 and 295 through 296.

VII. REGULATORY FLEXIBILITY ACT ANALYSIS

901. We certify that the Regulatory Flexibility Act[1875] is not applicable to the rule changes we are proposing for the LECs in this proceeding. In accordance with the provisions of Section 605 of that Act, a copy of this certification will be sent to the Chief Counsel for Advocacy of the Small Business Administration at the time of publication of a summary of this Further Notice in the Federal Register.

902. As part of our analysis of the proposal described in this Further Notice, however, this Commission has considered the impact of the proposal

---

1874 See also NYNEX Reply, App. E, for a discussion of savings related to price cap tariff filing procedures.

1875 Because of the nature of local exchange and access service, this Commission has concluded that small telephone companies are dominant in their fields of operation and therefore are not small entities as defined by the Regulatory Flexibility Act. See MTS and WATS Market Structure, 93 FCC 2d 241, 338-39 (1983). Thus, this Commission is not required by the terms of that Act to apply the formal procedures set forth therein. We are nevertheless committed to reducing the regulatory burdens on small telephone companies whenever possible consistent with our other public interest responsibilities. Accordingly, we have chosen to utilize, on an informal basis, appropriate Regulatory Flexibility Act procedures to analyze the effect of proposed regulations on small telephone companies.

on small telephone companies, i.e., those serving 50,000 or fewer access lines. As a result of our decision to make price cap regulation elective for depooled cost companies below the Tier 1 level, no small carrier will be forced to change the method by which it is regulated. Small companies that currently file their own cost-based access tariffs are free to remain under rate of return if they decide that rate of return is better suited to their circumstances than is price caps. Small carriers participating in the NECA pools, and for whom NECA files access tariffs, will not be forced to leave the pools as a result of the price cap rules we are proposing in this Notice. In addition, nothing in the price cap proposal would discontinue or impair the variety of programs we have established to provide support to small carriers. These programs, such as our High Cost Fund and long term support mechanisms, continue intact. Furthermore, average schedule companies that are or become affiliated with cost companies that are regulated under price caps would not need to relinquish average schedule, rate of return regulation. We have also proposed that, for companies that have not yet begun conversion to equal access, conversion costs be treated as exogenous costs under the price cap formula. This proposal ensures that small carriers, who are the least likely to have begun equal access conversion, can flow through these costs to their rates should they elect price caps. These proposals, when viewed in their totality, permit small, depooled cost companies to take advantage of the benefits of price cap regulation at their option, while ensuring that the status quo is maintained for small carriers that do not participate in price cap regulation.

VIII. EX PARTE REQUIREMENTS

903. For purposes of this non-restricted notice and comment rulemaking proceeding concerning LECs, members of the public are advised that ex parte presentations are permitted except during the "Sunshine Agenda" period. See generally Section 1.1206(a) of this Commission's Rules. The Sunshine Agenda period is the period of time which commences with the release of a public notice that a matter has been placed on the Sunshine Agenda and terminates when this Commission (1) releases the text of a decision or Order in the matter; (2) issues a public notice stating that the matter has been deleted from the Sunshine Agenda; or (3) issues a public notice stating that the matter has been returned to the staff for further consideration, whichever occurs first. See Section 1.1202(f) of this Commission's Rules. During the Sunshine Agenda period, no presentations, ex parte or otherwise, are permitted unless specifically requested by this Commission or Commission staff for the clarification or adduction of evidence or the resolution of issues in the proceeding. See Section 1.1203 of this Commission's Rules.

904. In general, an ex parte presentation is any presentation directed to the merits or outcome of the proceeding made to decision-making personnel which (1) if written, is not served on the parties to the proceeding; or (2) if oral, is made without advance notice to the parties to the proceeding and without opportunity for them to be present. See Section 1.1202(b) of this Commission's Rules. Any person who submits a written ex parte presentation

must provide on the same day it is submitted a copy of that presentation to this Commission's Secretary for inclusion in the public record. Any person who makes an oral ex parte presentation that presents data or arguments not already reflected in the person's previously-filed written comments, memoranda, or filings in this proceeding must provide on the day of the oral presentation a written memorandum to the Secretary (with a copy to the Commissioner or staff member involved) which summarizes the data and states on its face that the Secretary has been served, and also states by docket number the proceeding to which it relates. See Section 1.1206 of this Commission's Rules.

905. All relevant and timely comments and reply comments will be considered by this Commission. In reaching our decision, this Commission may take into account information and ideas not contained in the comments, provided that such information or a writing containing the nature and source of such information is placed in the public file, and provided that the fact of this Commission's reliance on such information is noted in the Order.

IX. ORDERING CLAUSES

906. Accordingly, IT IS ORDERED that, pursuant to Sections 4(i), 4(j), 201-205, 303(r), and 403 of the Communications Act of 1934, 47 U.S.C. §§ 154(i), 154(j), 201-205, 303(r), 403, and Section 553 of Title 5, United States Code, that Part 1, Part 61, Part 65, and Sections 1.773(a)(1), 61.11, 61.12, 61.13, 61.14, 61.15, 61.16, 61.17, 61.18, 61.19, 61.20, 61.21, 61.22, 61.23, 61.24, 61.25, 61.26, 61.32, 61.33, 61.38, 61.58, 65.1, 65.600, 65.701, 65.703 of this Commission's Rules, 47 C.F.R. Part 1, Part 61, Part 65, §§ 1.773(a)(1), 61.11, 61.12, 61.13, 61.14, 61.15, 61.16, 61.17, 61.18, 61.19, 61.20, 61.21, 61.22, 61.23, 61.24, 61.25, 61.26, 61.32, 61.33, 61.38, 61.58, 65.1, 65.600, 65.701, 65.703, ARE AMENDED as set forth in Appendix B to this Order, and that Part 1 and Part 61 of this Commission's Rules ARE AMENDED by adding Sections 61.3, 61.41, 61.42, 61.43, 61.44, 61.45, 61.46, 61.47, and 61.48 as set forth in Appendix B to this Order.

907. IT IS FURTHER ORDERED that, pursuant to Sections 4(i), 4(j), 201-205, 303(r), and 403 of the Communications Act of 1934, 47 U.S.C §§ 154(i), 154(j), 201-205, 303(r), 403, and Section 553 of Title 5, United States Code, NOTICE IS HEREBY GIVEN of proposed amendments to Part 61, Part 65, and Part 69, and Sections 61.3, 61.38, 61.39, 61.41, 61.42, 61.43, 61.44, 61.45, 61.48, 61.49, 61.58, 65.1, 65.600, 65.701, 65.703, 69.1, 69.3, 69.101, 69.105, 69.111, 69.113, 69.114, 69.205, 69.301, 69.302, 69.303, 69.304, 69.305, 69.306, 69.307, 69.308, 69.309, 69.310, 69.401, 69.402, 69.403, 69.404, 69.405, 69.406, 69.407, 69.408, 69.409, 69.410, and 69.411 of this Commission's Rules, 47 C.F.R. Part 61, Part 65, and Part 69, §§ 61.3, 61.38, 61.39, 61.41, 61.42, 61.43, 61.44, 61.45, 61.48, 61.49, 61.58, 65.1, 65.600, 65.701, 65.703, 69.1, 69.3, 69.101, 69.105, 69.111, 69.113, 69.114, 69.205, 69.301, 69.302, 69.303, 69.304, 69.305, 69.306, 69.307, 69.308, 69.309, 69.310, 69.401, 69.402, 69.403, 69.404, 69.405, 69.406, 69.407, 69.408,

69.409, 69.410, 69.411, in accordance with the proposals, discussion, and statement of issues in this Second Further Notice of Proposed Rulemaking, and as set forth in Appendix D to this Order, and that COMMENT IS SOUGHT regarding such proposals, discussion, and statement of issues.

908. IT IS FURTHER ORDERED that the motion to accept late-filed comments submitted by the National Association or Regulatory Utility Commissioners IS GRANTED. .

909. IT IS FURTHER ORDERED that the motion to accept late-filed reply comments submitted by the United Church of Christ Office of Communication IS GRANTED.

910. IT IS FURTHER ORDERED that the motion to pursue further investigation submitted by the Florida Public Counsel IS GRANTED IN PART AND DENIED IN PART to the extent indicated herein.

911. IT IS FURTHER ORDERED that the motion for further proceedings submitted by the Competitive Telecommunications Association, the Consumer Federation of America, the International Communications Association, the National Association of Regulatory Utility Commissioners, and MCI Telecommunications Corporation IS GRANTED IN PART AND DENIED IN PART to the extent indicated herein.

912. IT IS FURTHER ORDERED that, in accordance with the provisions of Section 1.419(b) of this Commission's Rules, 47 C.F.R. § 1.419(b), an original and five copies of all comments, replies, pleadings, briefs, and other documents filed in the proceeding SHALL BE FURNISHED to this Commission. In addition, parties should file ten copies of any such pleadings with the Price Cap Task Force, Common Carrier Bureau, Room 518, 1919 M Street, N.W., Washington, D.C. 20554. Parties should also file one copy of any documents filed in this docket with this Commission's copy contractor, International Transcription Services, Inc., Suite 140, 2100 M Street, N.W. Washington, D.C. 20037. Members of the public who wish to express their views by participating informally may do so by submitting one or more copies of their comments without regard to form (so long as the docket number is clearly stated at the heading). Copies of all filings will be available for public inspection during regular business hours in this Commission's Docket Reference Room (Room 239) at our headquarters at 1919 M Street, N.W., Washington, D.C.

913. IT IS FURTHER ORDERED that comments on this Second Further Notice of Proposed Rulemaking SHALL BE DUE not later than June 17, 1989, and that reply comments SHALL BE DUE not later than July 19, 1989.

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

APPENDIX A

Comments

The following parties filed comments in response to the Further Notice:

Ad Hoc Telecommunications Users Committee (Ad Hoc)
Aeronautical Radio, Inc. (Arinc)
Alabama Public Service Commission (Alabama PSC)
State of Alaska (Alaska)
Alarm Industry Communications Committee (Alarm Industry)
ALC Communications Corporation (ALC)
Alltel Corporation (Alltel)
Alternative Carrier Telecommunications Association (ACTA)
American Association of Retired Persons (AARP)
American Petroleum Institute (API)
American Telephone and Telegraph Company (AT&T)
Ameritech Operating Companies (Ameritech)
Arkansas Public Service Commission (Arkansas PSC)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
British Telecommunications plc (British Telecom)
Cable and Wireless Communications, Inc. (Cable & Wireless)
California Public Utilities Commission and People of the State of California (California PUC)
Capital Cities/ABC, Inc., CBS Inc., and National Broadcasting Company, Inc. (Networks)
Central Telephone Company (Centel)
Century Telephone Enterprises (Century)
Cincinnati Bell Telephone Company (CBT)
Colorado Office of Consumer Counsel (Colorado OCC)
Communications Satellite Corporation (Comsat)
Communications Workers of America (CWA)
Competitive Telecommunications Association (Comptel)
Computer and Communications Industry Association (CCIA)
Connecticut Office of Consumer Counsel (Connecticut OCC)
Consumer Federation of America (jointly with United Church of Christ) (CFA)
Contel Corporation (Contel)
District of Columbia Public Service Commission (DC PSC)
Electronic Data Systems Corporation (EDS)
Federal Executive Agencies (Executive Agencies)
Florida Public Service Commission (Florida PSC)
GTE Telephone Operating Companies (GTOC)
State of Hawaii (Hawaii)
Illinois Commerce Commission (Illinois)
Illinois Consolidated Telephone Company (Illinois Telco)
Independent Data Communications Manufacturers Association (IDCMA)
The Independents (Independents)

Indiana Office of Utility Consumer Counselor (jointly with the National Association of State Utility Consumer Advocates -- NASUCA) (Indiana UCC)
Information Industry Association (IIA)
Institutional Communications Company (ICC)
International Communications Association (ICA)
Lincoln Telephone Company (Lincoln)
Maryland People's Counsel (Maryland PC)
MCI Telecommunications Corporation (MCI)
Michigan Public Service Commission (Michigan PSC)
Missouri Public Service Commission (Missouri PSC)
Mountain States Telephone and Telegraph Company, Northwestern Bell Telephone Company and Pacific Northwest Bell Telephone Company (US West)
Multinational Business Services (MBS)
National Association of Manufacturers (NAM)
National Exchange Carrier Association (NECA)
National Rural Telecom Association (NRTA)
National Telecommunications and Information Administration (NTIA)
National Telecommunications Network (NTN)
National Telephone Cooperative Association (NTCA)
Nevada Public Utilities Commission (Nevada PUC)
New Hampshire Public Utilities Commission (New Hampshire PUC)
New York State Department of Public Service (New York DPS)
New York Telephone Company and New England Telephone and Telegraph Company (NYNEX)
Ohio Public Utilities Commission (Ohio PUC)
Organization for the Protection
and Advancement of Small Telephone Companies (OPASTCO)
Pacific Bell and Nevada Bell (Pactel)
Pennsylvania Office of Consumer Advocate (Pennsylvania OCA)
Puerto Rico Telephone Company (PRTC)
Rochester Telephone Corporation (Rochester)
Small Business Administration (SBA)
Southern New England Telephone Company (SNET)
Southwestern Bell Telephone Company (SWB)
Tele-Communications Association (TCA)
Telephone and Data Systems (TDS)
Telocator
US Sprint Communications Company (US Sprint)
United States Telephone Association (USTA)
United States Transmission Systems, Inc. (USTS)
United Telecommunications, Inc. (United)
Virginia State Corporation Commission (Virginia)
Wisconsin Public Service Commission (Wisconsin PSC)

Replies

The following parties filed replies in this proceeding:

Ad Hoc
Alabama
Alascom, Inc. (Alascom)
Alltel
Ameritech
API
Arinc
AT&T
Bell Atlantic
BellSouth
Cable & Wireless
CBT
Centel
CFA
Comptel
Contel
District of Columbia Office of People's Counsel (DC PC)
Florida's Citizens
Florida PSC
GTOC
Hawaii
ICA
ICC
IDCMA
Independents
Indiana UCC
Maryland PC
MCI
National Association of Regulatory Utility Commissioners (NARUC)
Networks
NTCA
NTN
New York DPS
New York City and Energy Telecommunications Office (NY EnerTel)
NYNEX
Ohio Office of Consumer's Counsel (Ohio OCC)
Ohio PUC
Oklahoma Corporation Commission (Oklahoma)
OPASTCO
Oregon Public Utility Commission (Oregon PUC)
Pactel
PRTC
Rochester
SNET

SWB
TCA
TDS
Telephone Utilities Exchange Carrier Association (TUECA)
Texas Public Utility Commission (Texas PUC)
United Church of Christ (UCC)
United
US Sprint
USTA
US West
Virginia

APPENDIX B

Amendments to Code of Federal Regulations

PART 1 -- PRACTICE AND PROCEDURE

1. The authority citation for Part 1 continues to read as follows:

Authority: Secs. 4, 303, 48 Stat. 1066, 1082, as amended 47 U.S.C. 154, 303; Implement, 5 U.S.C. 552, unless otherwise noted.

2. § 1.773(a)(1) is amended by adding a new subparagraph (iv) as follows:

§ 1.773 Petitions for suspension or rejection of new tariff filings.

(a)(1) * * *

(iv) For the purposes of this section, tariff filings made pursuant to § 61.49(b) by carriers subject to price cap regulation will be considered prima facie lawful, and will not be suspended by the Commission unless the petition shows that the support information required in § 61.49(b) was not provided, or unless the petition requesting suspension shows each of the following:

(A) That there is a high probability the tariff would be found unlawful after investigation;

(B) That the suspension would not substantially harm other interested parties;

(C) That irreparable injury will result if the tariff filing is not suspended; and

(D) That the suspension would not otherwise be contrary to the public interest.

PART 61 -- TARIFFS

1. The Table of Contents to Part 61 is revised to read as follows:

PART 61 -- TARIFFS

Subpart A -- General

Sec.
61.1 Purpose and application.
61.2 Clear and explicit explanatory statements.
61.3 Definitions.

Subpart B -- General Filing Requirements; Supporting Information

61.32 Method of filing publications.
61.33 Letters of transmittal.
61.35 Delivered free of charges.
61.36 Tariff publications not returned.
61.38 Supporting information to be submitted with letters of transmittal.
61.39 Optional supporting information to be submitted with letters of transmittal for Access Tariff filings effective on or after April 1, 1989, by local exchange carriers serving 50,000 or fewer access lines in a given study area that are described as subset 3 carriers in § 69.602.
61.40 Private line rate structure guidelines.
61.41 Price cap requirements generally.
61.42 Price cap baskets and service categories.
61.43 Annual price cap filings required.
61.44 Adjustments to the PCI.
61.45 [Reserved]
61.46 Adjustments to the API.
61.47 Adjustments to the SBI; pricing bands.
61.48 Transition rules for price cap formula calculations.
61.49 Supporting information to be submitted with letters of transmittal for tariffs of carriers subject to price cap regulation.

Subpart C -- Specific Rules for Tariff Publications

61.52 Form, size, type, legibility, etc.
61.53 Consecutive numbering.
61.54 Composition of tariffs.
61.56 Supplements.
61.57 Cancellations.
61.58 Notice requirements.
61.59 Effective period required before changes.
61.67 New or discontinued telephone and teletypewriter service points; mileages.
61.68 Special notations.

61.69 Rejection.
61.71 Reissued matter.
61.72 Posting.
61.73 Duplication of rates or regulations.
61.74 References to other instruments.

Subpart D -- Concurrences

61.131 Scope.
61.132 Method of filing concurrences.
61.133 Format of concurrences.
61.134 Concurrences for through services.
61.135 Concurrences for other purposes.
61.136 Revocation of concurrences.

Subpart E -- Applications for Special Permission

61.151 Scope.
61.152 Terms of applications and grants.
61.153 Method of filling applications.

Subpart F -- Adoption of Tariffs and Other Documents of Predecessor Carriers

61.171 Adoption notice.
61.172 Changes to be incorporated in tariffs of successor carrier.

Subpart G -- Suspensions

61.191 Carrier to file supplement when notified of suspension.
61.192 Contents of supplement announcing suspension.
61.193 Vacation of suspension order; supplements announcing same; etc.

2. The authority citation for Part 61 continues to read as follows:

Authority: Sec. 4, 48 Stat. 1066, as amended; 47 U.S.C. 154. Interpret or apply sec. 203, 48 Stat. 1070; 47 U.S.C. 203.

3. Section 61.3 is added as follows:

§ 61.3 Definitions.

(a) Act. The Communications Act of 1934 (48 Stat. 1004; 47 U.S.C. Chapter 5), as amended.

(b) Actual Price Index (API). An index of the level of aggregate rate element rates in a basket, which index is calculated pursuant to § 61.46.

(c) Association. This term has the meaning given it in § 69.2(d).

(d) Band. A zone of pricing flexibility for a service category, which zone is calculated pursuant to § 61.47.

(e) Base period. The 12-month period ending six months prior to the effective date of annual price cap tariffs.

(f) Basket. Any class or category of tariffed services: (1) which is established by the Commission pursuant to price cap regulation; (2) the rates of which are reflected in an Actual Price Index; and (3) the related costs of which are reflected in a Price Cap Index.

(g) Change in rate structure. A restructuring or other alteration of the rate components for an existing service.

(h) Charges. The price for service based on tariffed rates.

(i) Commercial contractor. The commercial firm to whom the Commission annually awards a contract to make copies of Commission records for sale to the public.

(j) Commission. The Federal Communications Commission.

(k) Concurring carrier. A carrier (other than a connecting carrier) subject to the Act which concurs in and assents to schedules of rates and regulations filed on its behalf by an issuing carrier or carriers.

(l) Connecting carrier. A carrier engaged in interstate or foreign communication solely through physical connection with the facilities of another carrier not directly or indirectly controlling or controlled by, or under direct or indirect common control with, such carrier.

(m) Corrections. The remedy of errors in typing, spelling, or punctuation.

(n) Dominant carrier. A carrier found by the Commission to have market power (i.e., power to control prices).

(o) GNP Price Index (GNP-PI). The estimate of the "Fixed-Weighted Price Index for Gross National Product, 1982 Weights" published by the United States Department of Commerce, which the Commission designates by Order.

(p) Issuing carrier. A carrier subject to the Act that publishes and files a tariff or tariffs with the Commission.

(q) Local Exchange Carrier. A telephone company that provides telephone exchange service as defined in section 3(r) of the Act.

(r) New service offering. A tariff filing that provides for a class or sub-class of service not previously offered by the carrier involved and that enlarges the range of service options available to ratepayers.

(s) Non-dominant carrier. A carrier not found to be dominant.

(t). Other participating carrier. A carrier subject to the Act that publishes a tariff containing rates and regulations applicable to the portion or through service it furnishes in conjunction with another subject carrier.

(u) Price Cap Index (PCI). An index of costs facing carriers subject to price cap regulation, which index is calculated for each basket pursuant to § 61.44.

(v) Price cap regulation. A method of regulation of dominant carriers provided in §§ 61.41 through 61.49.

(w) Price cap tariff. Any tariff filing involving a service that is within a price cap basket, or that requires calculations pursuant to § 61.44, § 61.46, or § 61.47.

(x) Productivity factor. An adjustment factor (3.0 percent) used to make annual adjustments to the Price Cap Index to reflect the margin by which a carrier subject to price cap regulation is expected to improve its productivity relative to the economy as a whole.

(y) Rate. The tariffed price per unit of service.

(z) Rate increase. Any change in a tariff which results in an increased rate or charge to any of the filing carrier's customers.

(aa) Rate level change. A tariff change that only affects the actual rate associated with a rate element, and does not affect any tariff regulations or any other wording of tariff language.

(bb) Regulations. The body of carrier prescribed rules in a tariff governing the offering of service in that tariff, including rules, practices, classifications, and definitions.

(cc) Restructured service. An offering which represents the modification of a method of charging or provisioning a service; or the introduction of a new method of charging or provisioning that does not result in a net increase in options available to customers.

(dd) Service Band Index (SBI). An index of the level of aggregate rate element rates in a service category, which index is calculated pursuant to § 61.47.

(ee) Service category. Any group of rate elements subject to price cap regulation, which group is subject to a band.

(ff) Supplement. A publication filed as part of a tariff for the purpose of suspending or cancelling that tariff, or tariff publication and numbered independently from the tariff page series.

(gg) Tariff. Schedules of rates and regulations filed by common carriers.

(hh) Tariff publication, or publication. A tariff, supplement, revised page, additional page, concurrence, notice of revocation, adoption notice, or any other schedule of rates or regulations.

(ii) Text change. A change in the text of a tariff which does not result in a change in any rate or regulation.

(jj) United States. The several States and Territories, the District of Columbia, and the possessions of the United States.

4. Sections 61.11, 61.12, 61.13, 61.14, 61.15, 61.16, 61.17, 61.18, 61.19, 61.20, 61.21, 61.22, 61.23, 61.24, 61.25, and 61.26 are removed and reserved.

5. The fifth sentence of section 61.32 is revised to read as follows:

§ 61.32 Method of filing publications.

* * * Simultaneously with the filing of the publications and by the same means, the issuing carrier must send a copy of the publication, supporting information specified in § 61.38, or, as appropriate, § 61.49, and transmittal letter to the commercial contractor (at its office on Commission premises) and the Chief, Tariff Review Branch. * * *

6. Section 61.33 is amended to redesignate paragraphs (c), (d), and (e) as paragraphs (d), (e), and (f), and to add a new paragraph (c) as follows:

§ 61.33 Letters of transmittal.

* * * * *

(c) In addition to the requirements set forth in paragraph (a) of this section, any carrier filing a price cap tariff must include in the letter of transmittal a statement that the filing is made pursuant to § 61.49.

7. Section 61.33(d), as so redesignated in paragraph 6, supra, is revised as follows:

(d) In addition to the requirements set forth in paragraphs (a), (b), and (c) of this section, the letter of transmittal must specifically reference by number any special permission necessary to implement the tariff publication. Special permission must be granted prior to the filing of the tariff publication, and may not be requested in the transmittal letter.

8. Section 61.38(a) is amended by adding a new sentence at the end thereof as follows:

§ 61.38 Supporting information to be submitted with letters of transmittal.

(a) * * * This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in §§ 61.42(a),(b),and (d), which filings are submitted by carriers subject to price cap regulation.

9. Sections 61.41 through 61.49 are added as follows:

§ 61.41 Price cap requirements generally.

Sections 61.42 through 61.49 apply to dominant interexchange carriers, as specified by Commission order.

§ 61.42 Price cap baskets and service categories.

(a) Each dominant interexchange carrier subject to price cap regulation shall establish three baskets as follows:

(1) A residential and small business services basket;

(2) An 800 service basket; and

(3) A business services basket.

(b)(1) The residential and small business basket shall contain such services as the Commission shall permit or require, including the following service categories: (i) Domestic day MTS; (ii) Domestic evening MTS; (iii) Domestic night/weekend MTS; (iv) International MTS; (v) Operator and credit card services; and (vi) Reach Out America.

(2) The 800 service basket shall contain such services as the Commission shall permit or require, including the following service categories: (i) Readyline 800; (ii) AT&T 800; (iii) Megacom 800; and (iv) Other 800.

(3) The business services basket shall contain such services as the Commission shall permit or require, including the following service categories: (i) ProAmerica I, II, and III; (ii) WATS; (iii) Megacom; (iv) SDN; (v) Other switched; (vi) Voice grade private line and below; and (vii) Other private line.

(c) Dominant interexchange carriers subject to price cap regulation shall exclude the following offerings from their price cap baskets:

(1) Special construction services;

(2) American Telephone and Telegraph Company Tariff F.C.C. No. 11 services;

(3) Such custom tariff services as the Commission may specify; and

(4) Such other services as the Commission may specify.

(d) New services, other than those within the scope of paragraph (c) of this section, must be included in the affected basket at the first annual price cap tariff filing following completion of the base period in which they are introduced. To the extent that such new services are permitted or required to be included in new or existing service categories within the assigned basket, they shall be so included at the first annual price cap tariff filing following completion of the base period in which they are introduced.

§ 61.43 Annual price cap filings required.

Carriers subject to price cap regulation shall submit annual price cap tariff filings that propose rates for the upcoming year, that make appropriate adjustments to their PCI, API, and SBI values pursuant to §§ 61.44, 61.46, and 61.47, and that incorporate the costs and rates of new services into the PCI, API, or SBI calculations pursuant to §§ 61.44(g), 61.46(b), and 61.47 (b) and (c). Carriers may propose rate or other tariff changes more often than annually, consistent with the requirements of § 61.59.

§ 61.44 Adjustments to the PCI.

(a) Carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year access and exogenous cost changes.

(b) Subject to paragraph (d) of this section, adjustments to each basket's PCI shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1}[1 + w(GNP\text{-}PI - X) + \Delta Y/R + \Delta Z/R]$$

where

GNP-PI = the percentage change in the GNP-PI between the quarter ending six months prior to the

effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

ΔY = (new access rate - access rate at the time the PCI was updated to PCI_{t-1}) x (base period demand),

ΔZ = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w = R - (access rate in effect at the time the PCI was updated to PCI_{t-1} x base period demand) + ΔZ, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

(c) The exogenous cost changes represented by the term "ΔZ" in the formula detailed in paragraph (b), shall be limited to those cost changes that the Commission shall permit or require, and include those caused by (1) the completion of the amortization of depreciation reserve deficiencies; (2) changes in the Uniform System of Accounts; (3) changes in the Separations Manual; (4) the reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; and (5) such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require. These exogenous cost changes shall be apportioned on a cost-causative basis between price cap services as a group, and excluded services as a group. Exogenous cost changes thus attributed to price cap services shall be further apportioned on a cost-causative basis among price cap baskets.

(d) In calculating the "ΔY" variable in the formula detailed in paragraph (b): (i) the net change in total non-traffic sensitive access costs for all capped services (in all baskets), calculated at base period demand, shall be allocated among the baskets in proportion to each basket's share of total base period non-traffic sensitive minutes of access (both originating and terminating); (ii) the net change in total traffic sensitive access costs for all capped services (in all baskets), calculated at base period demand,

shall be allocated among the baskets in proportion to each basket's share of total base period traffic sensitive minutes of access; and (iii) changes in special access costs in each basket, calculated at base period demand, shall be assigned directly to the baskets in which such costs are incurred.

(e) In calculating the "w" variable in the formula detailed in paragraph (b), the access costs that must be subtracted from the "R" variable shall be apportioned among the baskets in a manner that is consistent with the methodology provided in paragraph (d) for calculating the "ΔY" in each basket.

(f) The "w(GNP-PI - X)/100" component of the PCI formula shall be employed only in the adjustment made in connection with the annual price cap filing.

(g) The exogenous cost changes and changes in access costs caused by new services subject to price cap regulation must be included in the appropriate PCI calculations under paragraph (b) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced.

(h) In the event that a price cap tariff becomes effective, which tariff results in an API value (calculated pursuant to § 61.46) that exceeds the currently applicable PCI value, the PCI value shall be adjusted upward to equal the API value.

§ 61.45 [Reserved]

§ 61.46 Adjustments to the API.

(a) In connection with any price cap tariff filing proposing rate changes, the carrier must calculate an API for each affected basket pursuant to the following methodology:

$$API_t = API_{t-1} [\Sigma_i \, v_i \, (p_t/p_{t-1})_i]$$

where

API_t = the proposed API value,

API_{t-1} = the existing API value,

p_t = the proposed price for rate element "i,"

p_{t-1} = the existing price for rate element "i," and

v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of the base period demand for the rate element "i" priced at the existing rate, to the base

period demand for the entire basket of services priced at existing rates.

(b) New services subject to price cap regulation must be included in the appropriate API calculations under paragraph (a) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced. This index adjustment requires that the demand for the new service during the base period must be included in determining the weights used in calculating the API.

(c) Any price cap tariff filing proposing rate restructuring shall require an adjustment to the API pursuant to the general methodology described in paragraph (a) of this section. This adjustment requires the conversion of existing rates into rates of equivalent value under the proposed structure, and then the comparison of the existing rates that have been converted to reflect restructuring to the proposed restructured rates. This calculation may require use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the new restructured service) that will remain or become available after restructuring.

§ 61.47 Adjustments to the SBI; pricing bands.

(a) In connection with any price cap tariff filing proposing changes in the rates of service categories, the carrier must calculate an SBI value for each affected service category pursuant to the following methodology:

$$SBI_t = SBI_{t-1}[\Sigma_i \, v_i(p_t/p_{t-1})_i]$$

where

SBI_t = the proposed SBI value,

SBI_{t-1} = the existing SBI value,

p_t = the proposed price for rate element "i,"

p_{t-1} = the existing price for rate element "i," and

v_i = the current estimated revenue weight for rate element "i," calculated as the ratio of base period demand for rate element "i" priced at the existing rate, to the base period demand for the entire group of rate elements comprising the service category priced at existing rates.

(b) New services that are added to existing service categories must be included in the appropriate SBI calculations under paragraph (a) of this section beginning at the first annual price cap tariff filing following

completion of the base period in which they are introduced. This index adjustment requires that the demand for the new service during the base period must be included in determining the weights used in calculating the SBI.

(c) In the event that the introduction of a new service requires the creation of a new service category, a new SBI must be established for that service category beginning at the first annual price cap tariff filing following completion of the base period in which the new service is introduced. The new SBI should be initialized at a value of 100, corresponding to the service category rates in effect the last day of the base period, and thereafter should be adjusted as provided in paragraph (a) of this section.

(d) Any price cap tariff filing proposing rate restructuring shall require an adjustment to the affected SBI pursuant to the general methodology described in paragraph (a) of this section. This adjustment requires the conversion of existing rates in the rate element group into rates of equivalent value under the proposed structure, and then the comparison of the existing rates that have been converted to reflect restructuring to the proposed restructured rates. This calculation may require use of carrier data and estimation techniques to assign customers of the preexisting service to those services (including the new restructured service) that will remain or become available after restructuring.

(e) Pricing bands shall be established each tariff year for each service category within a basket. Except as provided in paragraph (f) of this section, each band shall limit the pricing flexibility of the service category, as reflected in its SBI, to an annual increase or decrease of five percent, relative to the percentage change in the PCI for that basket, measured from the levels in effect on the last day of the preceding tariff year.

(f) The upper pricing bands for the evening MTS and night/weekend MTS service categories shall limit the annual upward pricing flexibility for those service categories, as reflected in their SBIs, to four percent, relative to the percentage change in the PCI for the residential and small business services basket, measured from the last day of the preceding tariff year.

(g) Dominant interexchange carriers subject to price cap regulation shall calculate a composite average rate for services contained in the residential and small business services basket that are purchased by residential customers. Notwithstanding paragraphs (e) and (f) of this section, the annual upward pricing flexibility for this composite average rate shall be limited to one percent, relative to the percentage change in the PCI for the residential and small business services basket, measured from the last day of the preceding tariff year.

§ 61.48 Transition rules for price cap formula calculations.

(a) Dominant interexchange carriers subject to price cap regulation shall file initial price cap tariffs May 17, 1989, to be effective July 1, 1989.

(b) In connection with the initial price cap tariff filing described in paragraph (a) of this section, each PCI, API, and SBI shall be assigned an initial value prior to adjustment of 100, corresponding to the costs and rates in effect as of December 31, 1988.

§ 61.49 Supporting information to be submitted with letters of transmittal for tariffs of carriers subject to price cap regulation.

(a) Each price cap tariff filing must be accompanied by supporting materials sufficient to calculate required adjustments to each PCI, API, and SBI pursuant to the methodologies provided in §§ 61.44, 61.46, and 61.47.

(b) Each price cap tariff filing that proposes rates that are within applicable bands established pursuant to § 61.47, and that results in an API value that is equal to or less than the applicable PCI value, must be accompanied by supporting materials sufficient to establish compliance with the applicable bands, and to calculate the necessary adjustment to the affected APIs and SBIs pursuant to §§ 61.46 and 61.47, respectively.

(c) Each price cap tariff filing that proposes rates above the applicable band limits established in §§ 61.47(e) and (f), or above the limit on composite average residential rates established in § 61.47(g), must be accompanied by supporting materials establishing substantial cause for the proposed rates.

(d) Each price cap tariff filing that proposes service category rates below applicable band limits established in § 61.47(e), must be accompanied by supporting materials establishing that the rates cover the service category's average variable cost.

(e) Each price cap tariff filing that proposes rates that will result in an API value that exceeds the applicable PCI value must be accompanied by: (i) an explanation of the manner in which all costs have been allocated among baskets; and (ii) within the affected basket, a cost assignment showing down to the lowest possible level of disaggregation, including a detailed explanation of the reasons for the prices of all rate elements to which costs are not assigned.

(f) Each price cap tariff filing that proposes restructuring of existing rates must be accompanied by supporting materials sufficient to make the adjustments to each affected API and SBI required by §§ 61.46(c) and 61.47(d), respectively.

(g) Each tariff filing that introduces a new service that will later be included in a basket must be accompanied by cost data sufficient to establish that the new service, and each unbundled element thereof, will

generate a net revenue increase -- measured against revenues generated from all services subject to price cap regulation, and calculated based upon present value -- within the lesser of a 24-month period after an annual price cap tariff including the new service takes effect, or 36 months from the date the new service becomes effective. Each such tariff filing must also be accompanied by data sufficient to make the API and PCI calculations required by §§ 61.46(b) and 61.44(g), and, as necessary, to make the SBI calculations provided in §§ 61.47(b) or (c).

10. Section 61.58 is amended to redesignate paragraph (c) as paragraph (d), and to add a new paragraph (c) as follows:

§ 61.58 Notice requirements.

* * * * *

(c) Carriers subject to price cap regulation. This paragraph applies only to carriers subject to price cap regulation. Such carriers must file tariffs according to the following notice periods.

(1) For annual adjustments to the PCI, API, and SBI values under §§ 61.44, 61.46, and 61.47, respectively, tariff filings must be made on at least 45 days' notice.

(2) Tariff filings that alter rate levels only, and that (i) do not cause any API to exceed any applicable PCI pursuant to calculations provided for in § 61.46; and (ii) do not cause any SBI to exceed its banding limitations established in § 61.47, must be made on at least 14 days' notice.

(3) Tariff filings that will cause any API to exceed its applicable PCI pursuant to calculations provided for in § 61.46, that will cause any SBI to exceed its upper banding limitations established in §§ 61.47(e) and (f), or that will cause the composite average residential rate to exceed its limitation on upward pricing flexibility established in § 61.47(g), must be made on at least 90 days' notice.

(4) Tariff filings that will cause any SBI to decrease below its lower banding limit established in § 61.47(e), must be made on at least 45 days' notice.

(5) Tariff filings involving a change in rate structure of a service included in a basket listed in § 61.42(a), or the introduction of a new service within the scope of § 61.42(d), must be made on at least 45 days' notice.

(6) The required notice for tariff filings involving services included in § 61.42(c), or involving changes to tariff regulations, shall be that required in connection with such filings by dominant carriers that are not subject to price cap regulation.

11. The first sentence of section 61.58(d), as so redesignated in paragraph 10, supra, is revised to read as follows:

(d) Other carriers. (1) Tariff filings in the instances specified in paragraphs (d)(1) (i), (ii) and (iii) of this section must be made on at least 15 days' notice.

PART 65 -- INTERSTATE RATE OF RETURN PRESCRIPTION PROCEDURES AND METHODOLOGIES

1. The authority citation for Part 65 continues to read as follows:

Authority: Secs. 4, 201, 202, 203, 205, 218, 403, 48 Stat. 1066, 1072, 1077, 1094, as amended, 47 U.S.C. 154, 201, 202, 203, 205, 218, 403.

2. Section 65.1 is revised to read as follows:

§ 65.1 Application of Part 65.

This part establishes procedures and methodologies for Commission prescription of interstate rates of return. This part shall apply to those interstate services and carriers as the Commission shall designate by Order. This part and the existing rate of return prescription shall not apply to dominant interexchange carriers subject to §§ 61.41 through 61.49, except as set forth in §§ 65.600 (c), 65.701(c), and 65.703(g).

3. Section 65.600 is amended by removing existing paragraph (c), and by adding a new paragraph (c) as follows:

§ 65.600 Rate of return reports.

(a) * * *

(b) * * *

(c) Each interexchange carrier subject to §§ 61.41 through 61.49 shall file with the Commission, within three (3) months after the end of each calendar year, the total interstate rate of return for that year for all interstate services subject to regulation by the Commission. Each such filing shall include a report of the total revenues, total expenses and taxes, operating income, and the rate base. A copy of the filing shall be retained in the principal office of the respondent and shall be filed in such manner as to be readily available for reference and inspection.

4. Section 65.701 is amended by adding a new paragraph (c) as follows:

§ 65.701 Period of review.

(a) * * *

(b) * * *

(c) Notwithstanding other provisions in this subpart, the final period of review for any dominant interexchange carrier subject to price cap regulation (as defined in § 61.3(v)) shall end on June 30, 1989.

5. Section 65.703 is amended by revising paragraphs (a) and (f), and by adding a new paragraph (g) as follows:

§ 65.703 Refunds.

(a) For carriers not subject to §§ 61.41 through 61.49, refunds shall be effected automatically if a carrier's earnings for any category of services, as set forth in § 65.702, exceed the maximum allowable rate of return. In determining whether a carrier's earnings exceed the maximum allowable rate of return, the reports filed by a carrier shall be deemed conclusively binding on the carrier.

(b) * * *

(c) * * *

(d) * * *

(e) * * *

(f) For interexchange carriers subject to this Part, but not subject to §§ 61.41 through 61.49, tariffs reflecting the revenue requirement reductions effectuating the refund shall be filed on 45 days' notice no later than 60 days after submission of the final report for the earnings review period.

(g) For carriers subject to §§ 61.41 through 61.49, refund obligations incurred prior to the date their tariffs filed pursuant to §§ 61.41 through 61.49 take effect for the first time, shall be effectuated by an adjustment to the applicable Actual Price Index, Service Band Index, and Price Cap Index (as defined in § 61.3). Carriers making an adjustment to effectuate any outstanding refund requirements from the final enforcement period shall make such adjustments no later than during the next scheduled annual price cap adjustment tariff filing following the submission of the final enforcement report. The adjustment shall be designed to complete the required refund within 12 months, following which the Actual Price Index, the Service Band Index, or the Price Cap Index shall be adjusted to remove the effect of the adjustment.

APPENDIX C

Analysis of AT&T Productivity (1984-88)

Our analysis of AT&T's productivity begins with divestiture in January 1984, and extends through September, 1988. The first post-divestiture tariff went into effect in May, 1984, and Commission actions since that time include a number of significant changes in access charges (an exogenous expense) and in allowed prices. In addition, certain other exogenous expenses have undergone change. The following represents a chronology of these events, which are summarized in the Table attached to this Appendix. The dollar amounts of the changes reported for each of the events are computed on a prospective basis, i.e., the amounts are computed based on changes from the forecasted next year's values.

Event 1--May 24, 1984: The first annual access filing reduces AT&T's expenses by $1,400 million. AT&T lowers its prices (6.1 percent on MTS and WATS) to pass all $1,400 million through to consumers.[1]

Event 2--January 15, 1985: Access charges to AT&T are increased by $274 million. AT&T does not change its prices.[2]

Event 3--April 26, 1985: AT&T increases its prices to yield a revenue increase of $74 million.[3]

Event 4--April 27, 1985: AT&T's Private Line Restructure filing takes effect. The increase in revenues is $229 million.[4]

---

1 See Investigation of Access and Divestiture Related Tariffs, CC Docket No. 83-1145, Phase I, MTS and WATS Market Structure, CC Docket No. 78-72, Phase I, Mem. Op. & Order, FCC No. 84-201, released May 15, 1984, App. A, Table 9.

2 See National Exchange Carrier Association, Inc., Revisions to Tariff F.C.C. No. 1, Tr. No. 23, Order, Mimeo No. 1990, released Jan. 17, 1985.

3 See AT&T Communication, Revisions to Tariff F.C.C No. 1, Tr. No. 357; see also AT&T Communications Revisions to Tariff F.C.C. No. 1, Tr. No. 357, Mem. Op. & Order, Mimeo No. 36207, released Oct. 10, 1985. This amount is corrected from that shown in the Further Notice.

4 See AT&T Communications, Revisions to Tariffs F.C.C. Nos. 9, 10, 11; Transmittal No. 285, effective April 27, 1985; Transmittal No. 315, effective

Event 5--June 1, 1985: Access charges are decreased to AT&T by $1,157 million. AT&T lowers its prices to pass all $1,157 million through.[5]

Event 6--June, 1985 to January, 1986: The Account 645 interim phase down reduces Billing and Collection charges AT&T paid to the LECs by $197 million.[6]

Event 7--October 1, 1985: Access charges to AT&T are decreased by $525 million and Equal Access rates are increased by $123 million. AT&T does not change its prices.[7]

Event 8--January 1, 1986: AT&T cuts its prices to reduce revenues by $135 million.[8]

Event 9--January 11, 1986: AT&T raises its Private Line rates by $248 million to implement Serving Wire Center Pricing, to recover its interim costs of providing private line access and to reflect the $67 million higher

---

March 4, 1985; Transmittal No. 318, effective April 27, 1985; Transmittal No. 338, effective March 29, 1985; and Transmittal No. 352, effective April 6, 1985.

5 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 1 and 2, Tr. No. 358; see also AT&T Communications, Revisions to Tariff F.C.C. Nos. 1 and 2, Tr. No. 358, Order, Mimeo No. 6186, released Aug. 7, 1985.

6 The change in total industry charges ($250.5 million) is reported in Data Response to Supplemental Information Request FCC Public Notice of April 23, 1986, Tier 1 Exchange Carrier Task Force to Secretary, Federal Communications Commission, May 7, 1986. AT&T's share is derived by multiplying the total industry number by AT&T's share of total access minutes for the third quarter 1985 through the first quarter 1986 (78.5%), as reported in AT&T's Share of the Interstate Switched Market: Second Quarter, 1988, Industry Analysis Division, Federal Communications Commission, Sept. 16, 1988. See also Letter from George D. Morlan, Director, Federal Regulation, AT&T, to Tariff Division staff, Oct. 12, 1988.

7 See Annual 1985 Access Tariff Filings, Order, Mimeo No. 7401, released Sept. 30, 1985.

8 See AT&T Communications, Revisions to Tariff F.C.C. No. 1, Tr. No. 514; see also AT&T Communications, Revisions to Tariff F.C.C. No. 1, Tr. 514, Order, Mimeo No. 4396, released May 9, 1986.

independent company access charges and a $42 million reduction in access expenses.[9]

Event 10--February 28, 1986: AT&T adjusts certain rate periods, increasing revenues $17 million.[10]

Event 11--April 15, 1986: AT&T implements a 3.3 percent rate increase on private line services. The revenue increase is $72 million.[11]

Event 12--June 1, 1986: Access charges are reduced to AT&T by $2,000 million. AT&T cuts its prices and passes through all $2,000 million.[12]

Event 13--January 1, 1987: Access charges to AT&T are cut by $1,865 million. AT&T passes through the entirety of these cuts.[13]

Event 14--March 13, 1987: AT&T Private Line Switched Services Network rates are reduced, producing a $28 million reduction in revenues.[14]

Event 15--March 13, 1987: AT&T increases rates for Private Line Intercity Services by 2.7 percent. The revenue increase is $46 million.[15]

---

9 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 9,10, and 11, Tr. No. 504, Nov. 27, 1985. See also Letter from George D. Morlan, Director, Federal Regulations, AT&T, to Tariff Division staff, Oct. 12, 1988.

10 See AT&T Communications, Revisions to Tariffs F.C.C. No. 1; Transmittal No. 530, effective Feb. 28, 1986.

11 See AT&T Communications, Revisions to Tariffs F.C.C. No. 9; Transmittal No. 560, effective April 15, 1986; and Transmittal No. 585, effective April 5, 1986.

12 See Midyear 1986 Access Tariff Filings, National Exchange Carrier Association, E.C.A. Tariff F.C.C. No. 1, Tr. Nos. 122 and 134, CC Docket No. 86-181, Order, Mimeo No. 4867, released May 30, 1986.

13 See Annual 1987 Access Tariff Filings, 2 FCC Rcd 866 (1986).

14 See AT&T Communications, Revisions to Tariffs F.C.C. Nos. 9; Transmittal No. 826, effective March 13, 1987.

15 See AT&T Communications, Revisions to Tariffs F.C.C Nos. 9; Transmittal No. 774, effective March 13, 1987; Transmittal No. 810, effective January 1, 1987; and Transmittal No. 827, effective March 13, 1987.

Event 16--July 1, 1987: Access charges to AT&T are reduced by $593 million. AT&T lowers its prices to pass through all the cost decrease.[16]

Event 17--December 27, 1987: AT&T implements rate increases for short-haul Private Line Voice Grade interoffice channels and central office connections. The revenue increase is $77 million.[17]

Event 18--January 1, 1988: Access charges paid by AT&T are decreased by $772 million. The Tax Simplification Act of 1987 results in a reduction of AT&T's tax liability in the amount of $315 million.[18] The change to Statement of Financial Accounting Standards (SFAS) - 87 pension accounting results in a cost reduction to AT&T of $209 million.[19] AT&T reduces its rates sufficiently to pass through the access charge reduction of $772 million.[20]

Event 19--June 17, 1988: AT&T changes to permitting one free Directory Assistance call instead of two, resulting in a $28 million revenue increase.[21]

Event 20--September 17, 1988: AT&T increases operator-handled rates by $174 million.[22]

---

16 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 1 and 2, Tr. No. 915, May 15, 1987.

17 See AT&T Communications, Revisions to Tariffs F.C.C. Nos. 9; Tr. No. 1059, Dec. 27, 1987.

18 The $315 million is the pre-tax effect. The $135 million included in the analysis in the Further Notice incorrectly reflected the after-tax effect.

19 Use of Generally Accepted Accounting Principles on Part 32 of the Commission's Rules, 2 FCC Rcd 6675 (1987).

20 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 1, 2, 11, 13, and 14, Tr. Nos. 1063 and 1064, CC Docket No. 87-611, Order, Mimeo No. 1128, released Dec. 30, 1987.

21 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 1, 2, and 13, Tr. No. 1205, May 3, 1988. See also Letter from George D. Morlan, Director, Federal Regulations, AT&T, to Tariff Division staff, Oct. 12,1988.

22 See AT&T Communications, Revisions to Tariff F.C.C. Nos. 1 and 13, Tr. No. 1238, June 1, 1988 and Revisions to Tariff No. F.C.C. 1, Tr. No. 1337, Sept. 1, 1988. See also Letter from George D. Morlan, Director, Federal Regulations, AT&T, to Tariff Division staff, Oct. 12, 1988.

Included in this study, in addition to these events, are amortizations from 1985 through 1988 for the interstate division of AT&T and for the thirteen of AT&T's interexchange carriers to which the amortizations apply. These amortizations affect AT&T's costs both directly, by increasing expenses, and indirectly, by changing the rate base on which AT&T earns a return. The rate base is affected by the change in the depreciation reserve and by the change in accumulated deferred income taxes. The amounts listed for these amortizations in the attached table are computed to reflect both the amortization amounts and the effect of these amortizations on the return on the rate base and on accumulated deferred income tax.[23]

From the table it is apparent that during this period, AT&T had a net reduction in its access charges and other exogenous costs of $8,087 million. Under our price cap plan this total would be entirely flowed through to consumers. AT&T's actual price reductions during this period, as shown in the table, amounted to $6,985 million. These price reductions were less than the $8,087 million changes in its exogenous costs by $1,102 million. This last figure represents the change in nominal prices (or revenues) that AT&T put into effect over the five-year period from January, 1984 to September, 1988. This averages to a $220.4 million per year increase.

Over the interval 1984-87, AT&T's direct costs, measured as its gross service revenues minus carrier's carrier expense, averaged $17,269 million per year.[24] We therefore conclude that as a percentage of its direct costs, AT&T's prices rose by 1.28 percent per year on average, calculated as $220.4 million divided by $17,269 million. The final step of the calculation is a determination of the magnitude of increase of the overall price level over the same period. Our proposed price index is the GNP Price Index, and we calculate changes to that index based on an annual period beginning eighteen months prior to the time that the new tariff goes into effect. Therefore, for the period in question, application of our plan would be based on the GNP-PI from the second calendar quarter of 1982 to the second calendar quarter of 1987. Over this period, the GNP-PI rose from 99.4 to 118.6, which is an annual rate of 3.60 percent.[25] Since AT&T's prices rose at an annual rate of

---

23 See The Prescription of Revised Depreciation Rates for: AT&T Communications of California, Inc, et al, FCC No. 85-568, Mem. Op. & Order, Mimeo No. 36245, released Oct. 23, 1985. See also The Prescription of Revised Depreciation Rates for AT&T Communications-Interstate Division, FCC No. 85-342, Mem. Op. & Order, Mimeo No. 35939, released July 9, 1985.

24 Computed from various editions of AT&T Communications Interstate Monthly Report No. 1. Figures for 1988 are not yet available. This figure is a correction of the $17,144 million used in the Further Notice.

25 See Survey of Current Business at Table 7.1 (various issues).

only 1.28 percent, we conclude that its added productivity accounts for the difference, namely, 2.32 percent per year.

Table

AT&T Cost & Revenue Changes

Date	Cost Change ($M)	Revenue Change ($M)	Net Change ($M)	Cause
05/25/84	-1400	-1400	0	Access
1/85-12/85	162		-162	Amortization
01/15/85	274		-274	Access
04/26/85		74	74	MTS Tariff
04/27/85		229	229	Private Line
06/01/85	-1157	-1157	0	Access
6/85-1/86	-197		197	Acct 645
10/01/85	-525		525	Access
10/01/85	123		-123	EqAc rate increase
01/01/86		-135	-135	Price Cut
1/86-12/86	146		-146	Amortization
01/11/86	25	248	223	Serving Wire Ctr
02/28/86		17	17	IMTS Tariff
04/15/86		72	72	Private Line
06/01/86	-2000	-2000	0	Access
01/01/87	-1865	-1865	0	Access
1/87-12/87	119		-119	Amortization
03/13/87		-28	-28	PL Switched
03/13/87		46	46	PL Intercity
07/01/87	-593	-593	0	Access
12/27/87		77	77	Private Line
01/01/88	-772	-772	0	Access
01/01/88	-315		315	Tax Act
01/01/88	-209		209	Accounting Change
1/88-12/88	97		-97	Amortization
06/17/88		28	28	DA increase
09/17/88		174	174	OP-H rate increase
TOTAL	-8087	-6985	1102	

APPENDIX D

PART 61 -- TARIFFS

1. The Table of Contents to Part 61 is revised to read as follows:

PART 61 -- TARIFFS

Subpart A -- General

Sec.
61.1 Purpose and applications.
61.2 Clear and explicit explanatory statements.
61.3 Definitions.

Subpart B -- General Filing Requirements; Supporting Information

61.32 Method of filing publications.
61.33 Letters of transmittal.
61.35 Delivered free of charges.
61.36 Tariff publications not returned.
61.38 Supporting information to be submitted with letters of transmittal.
61.39 Optional supporting information to be submitted with letters of transmittal for Access Tariff filings effective on or after January 1, 1989, by local exchange carriers serving 50, 000 or fewer access lines that are described as subset 3 carriers in § 69.602.
61.40 Private line rate structure guidelines.
61.41 Price cap requirements generally.
61.42 Price cap baskets and service categories.
61.43 Annual filings required.
61.44 Adjustments to the PCI for Dominant Interexchange Carriers.
61.45 Adjustments to the PCI for Local Exchange Carriers.
61.46 Adjustments to the API.
61.47 Adjustments to the SBI; pricing bands.
61.48 Transition rules for price cap formula calculations.
61.49 Supporting information to be submitted with letters of transmittal for tariffs of carriers subject to price cap regulation.

Subpart C -- Specific Rules for Tariff Publications

61.52 Form, size, type, legibility, etc.
61.53 Consecutive numbering.
61.54 Composition of tariffs.
61.56 Supplements.
61.57 Cancellations.
61.58 Notice requirements.
61.59 Effective period required before changes.
61.67 New or discontinued telephone and teletypewriter service points; mileages.
61.68 Special notations.

61.69 Rejection.
61.71 Reissued matter.
61.72 Posting.
61.73 Duplication of rates or regulations.
61.74 References to other instruments.

Subpart D -- Concurrences

61.131 Scope.
61.132 Method of filing concurrences.
61.133 Format of concurrences.
61.134 Concurrences for through services.
61.135 Concurrences for other purposes.
61.136 Revocation of concurrences.

Subpart E -- Applications for Special Permission

61.151 Scope.
61.152 Terms of applications and grants.
61.153 Method of filling applications.

Subpart F -- Adoption of Tariffs and Other Documents of Predecessor Carriers

61.171 Adoption of notice.
61.172 Changes to be incorporated in tariffs of successor carrier.

Subpart G -- Suspensions

61.191 Carrier to file supplement when notified of suspension.
61.192 Contents of supplement announcing suspension.
61.193 Vacation of suspension order; supplements announcing same; etc.

2. The authority citation for Part 61 continues to read as follows:

Authority: Sec. 4, 48 Stat. 1066, as amended; 47 U.S.C. 154. Interpret or apply sec. 203, 48 Stat. 1070; 47 U.S.C. 203.

3. Section 61.3 is amended by revising paragraphs (u) and (w) to read as follows:

§ 61.3 Definitions.

* * * * *

(u) Price Cap Index (PCI). An index of costs facing carriers subject to price cap regulation, which index is calculated for each basket pursuant to §§ 61.44 or 61.45.

* * * * *

(w) Price cap tariff. Any tariff filing involving a service that is within a price cap basket, or that requires calculations pursuant to §§ 61.44, 61.45, 61.46, or 61.47.

* * * * *

4. Section 61.38(a) is amended by revising the last sentence to read as follows:

§ 61.38 Supporting information to be submitted with letters of transmittal.

(a) * * * This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in §§ 61.42(a), (b), (d), (e), and (g), which filings are submitted by carriers subject to price cap regulation.

5. Section 61.39(a) is amended by adding the following new sentence at its end:

§ 61.39 Optional supporting information to be submitted with letters of transmittal for Access Tariff filings effective on or after January 1, 1989, by local exchange carriers serving 50,000 or fewer access lines that are described as subset 3 carrier in § 69.602.

(a) * * * This section (other than the preceding sentence of this paragraph) shall not apply to tariff filings proposing rates for services identified in §§ 61.42(d), (e), and (g), which filings are submitted by carriers subject to price cap regulation.

6. Section 61.41 is amended by removing the current paragraph and adding new paragraphs (a) and (b) as follows:

§ 61.41 Price cap requirements generally.

(a) Sections 61.42 through 61.49 shall apply as follows:

(1) To dominant interexchange carriers, as specified by Commission order;

(2) To Tier 1 local exchange carriers, as defined by Commission order, which are not participants in any Association tariff effective July 1, 1990, and to all local exchange carriers, other than average schedule companies, that are affiliated with such carriers; and

(3) On an elective basis, to local exchange carriers, other than those specified in paragraph (2), that are neither participants in any Association

tariff effective July 1, 1990, nor affiliated with any such participants, except that affiliation with average schedule companies shall not bar a carrier from electing price cap regulation provided the carrier is otherwise eligible.

(b) If a telephone company, or any one of a group of affiliated telephone companies, files a price cap tariff in one study area, that telephone company and its affiliates, except its average schedule affiliates, must file price cap tariffs in all their study areas. No telephone company that files a price cap tariff may participate in an Association tariff.

7. Section 61.42 is amended by redesignating paragraph (d) as paragraph (g) and revising the first sentence thereof, and by adding new paragraphs (d), (e), and (f) as follows:

§ 61.42 Price cap baskets and service categories.

* * * * *

(d) Each local exchange carrier subject to price cap regulation shall establish three baskets as follows:

(1) A basket for the carrier common line charge as described in § 69.105;

(2) A basket for traffic sensitive switched interstate access elements; and

(3) A basket for interstate services other than services described in paragraphs (d)(1) or (d)(2) of this section.

(e)(1) The traffic sensitive switched access basket shall contain such services as the Commission shall permit or require, including the following service categories: (i) local switching as described in § 69.106; (ii) information, as described in § 69.109; and (iii) transport, as described in § 69.111.

(2) The basket for interstate services other than interstate switched access services shall contain such services as the Commission shall permit or require, including special access, as described in § 69.113, and non-access services.

(f) Each local exchange carrier subject to price cap regulation shall exclude the following offerings from their price cap baskets:

(1) Special construction services;

(2) Services offered on an individual case basis (ICB).

(g) New services, other than those within the scope of paragraphs (c) and (f) of this section, * * *

8. Section 61.43 is amended by revising the first sentence to read as follows:

§ 61.43 Annual price cap filings required.

Carriers subject to price cap regulation shall submit annual price cap tariff filings that propose rates for the upcoming year, that make appropriate adjustments to their PCI, API, and SBI values pursuant to §§ 61.44 through 61.47, and that incorporate the costs and rates of new services into the PCI, API, or SBI calculations pursuant to §§ 61.44(g), 61.45(g), 61.46(b), and 61.47(b) and (c). * * * * *

9. Section 61.44 is amended by revising the first sentences of paragraphs (a) and (b) to read as follows:

§ 61.44 Adjustments to the PCI for Dominant Interexchange Carriers.

(a) Dominant interexchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year access and exogenous cost changes. * * *

(b) Subject to paragraph (d) of this section, adjustments to each PCI of dominant interexchange carriers subject to price cap regulation shall be made pursuant to the following formula: * *.*

* * * * *

10. New section 61.45 is added as follows:

§ 61.45 Adjustments to the PCI for Local Exchange Carriers.

(a) Local exchange carriers subject to price cap regulation shall file adjustments to the PCI for each basket as part of the annual price cap tariff filing, and shall maintain updated PCIs to reflect the effect of mid-year exogenous cost changes.

(b) Subject to paragraphs (e) and (f) of this section, adjustments to local exchange carrier PCIs for the baskets designated in §§ 61.42(d)(2) and (3) shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1}[1 + w(GNP\text{-}PI - X) + \Delta Z/R]$$

where

GNP-PI = the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

ΔY = (new access rate - access rate at the time the PCI was updated to PCI_{t-1}) x (base period demand),

ΔZ = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w = R -ΔZ, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

(c) Subject to paragraphs (e) and (f) of this section, adjustments to local exchange carrier PCIs for the basket designated in § 61.42(d)(1) shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1}[1 + w[(GNP\text{-}PI - X) + (g/2)(GNP\text{-}PI - X - 1)]/(1 + g) + \Delta Z/R]$$

where

GNP-PI = the percentage change in the GNP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 3.0%,

g = the ratio of minutes of use per access line during the base period, to minutes of use per access line during the previous base period,

ΔZ = the dollar effect of current regulatory changes when compared to the regulations in effect at

the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w = R + Z, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

(d) The exogenous cost changes represented by the term "ΔZ" in the formulas detailed in paragraphs (b) and (c), shall be limited to those cost changes that the Commission shall permit or require, and include those caused by (1) the completion of the amortization of depreciation reserve deficiencies; (2) changes in the Uniform System of Accounts; (3) changes in the Separations Manual; (4) changes to the level of obligation associated with the Long Term Support Fund and the Transitional Support Fund described in § 69.612; (5) the reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; and (6) such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require. These exogenous cost changes shall be apportioned on a cost-causative basis between price cap services as a group, and excluded services as a group. Exogenous cost changes thus attributed to price cap services shall be further apportioned on a cost-causative basis among the price cap baskets.

(e) The "w(GNP-PI - X)/100" component of the PCI formula contained in paragraph (b), and the "w[(GNP-PI - X) + (g/2)(GNP-PI - X - 1)]/(1 + g)" component of the PCI formula contained in paragraph (c) shall be employed only in the adjustment made in connection with the annual price cap filing.

(f)(1) In the event that a LEC subject to price cap regulation experiences a rate of return during any base period representing a return more than 2 percent above the rate of return prescribed for non-price cap LECs, the values assigned to the "PCI_{t-1}" component of that LEC's PCIs shall be adjusted downward to the levels that would have yielded a base period rate of return 2 percent above the prescribed rate of return; and (2) in the event that a LEC subject to price cap regulation experiences a rate of return during any base period representing a return more than 2 percent below the rate of return prescribed for non-price cap LECs, the values assigned to the "PCI_{t-1}" component of that LEC's PCIs shall be adjusted upward to the levels that would have yielded a base period rate of return 2 percent below the prescribed rate of return. The adjustment shall occur as part of the annual price cap filing immediately following the base period in which the LEC's return was outside the prevailing rate of return plus or minus 2 percent.

(g) The exogenous costs caused by new services subject to price cap egulation must be included in the appropriate PCI calculations under paragraphs (b) or (c) of this section beginning at the first annual price cap tariff filing following completion of the base period in which they are introduced.

(h) In the event that a price cap tariff becomes effective, which tariff results in an API value (calculated pursuant to § 61.46) that exceeds the currently applicable PCI value, the PCI value shall be adjusted upward to equal the API value.

11. Section 61.48 is amended by adding paragraphs (c), and (d) as follows:

§ 61.48 Transition rules for price cap formula calculations.

* * * * *

(c) Local exchange carriers subject to price cap regulation shall file initial price cap tariffs April 2, 1990, to be effective July 1, 1990.

(d) In connection with the initial price cap filing described in paragraph (c) of this section, each PCI, API, and SBI shall be assigned an initial value prior to adjustment of 100, corresponding to the costs and rates in effect as of December 31, 1989.

12. Section 61.49 is amended by revising paragraph (a) and the last sentence of paragraph (g) to read as follows:

§ 61.49 Supporting information to be submitted with letters of transmittal for tariffs of carriers subject to price cap regulation.

(a) Each price cap tariff filing must be accompanied by supporting materials sufficient to calculate required adjustments to each PCI, API, and SBI pursuant to the methodologies provided in §§ 61.44, 61.45, 61.46, and 61.47.

* * * * *

(g) * * * Each such tariff filing must also be accompanied by data sufficient to make the API and PCI calculations required by §§ 61.46(b), 61.44(g), and 61.45(g), and, as necessary, to make the SBI calculations provided in §§ 61.47(b) and (c).

13. Section 61.58(c) is amended by revising subparagraphs (c)(1), (c)(4), and (c)(5) to read as follows:

§ 61.58 Notice Requirements.

* * * * *

(c) Carriers subject to price cap regulation. * * *

(1) For annual adjustments to the PCI, API, and SBI values under §§ 61.44, 61.46, and 61.47, respectively, dominant interexchange carrier tariff filings must be made on at least 45 days' notice. For annual adjustments to the PCI, API, and SBI values under §§ 61.45, 61.46, and 61.47, respectively, local exchange carrier tariff filings must be made on not less than 90 days' notice.

* * * * *

(5) Tariff filings involving a change in rate structure of a service included in a basket listed in § 61.42(a) or § 61.42(d), or the introduction of a new service within the scope of § 61.42(g), must be made on at least 45 days' notice.

(6) The required notice for tariff filings involving services included in § 61.42(c) or § 61.42(f), or involving changes to tariff regulations, shall be that required in connection with such filing by dominant carriers that are not subject to price cap regulation.

PART 65 -- INTERSTATE RATE OF RETURN PRESCRIPTION PROCEDURES AND METHODOLOGIES

1. The authority citation for Part 65 continues to read as follows:

Authority: Secs. 4, 201, 202. 203, 205, 218, 403, 48 Stat. 1066, 1072, 1077, 1094, as amended, 47 U.S.C. 154, 201, 202, 203, 205. 218, 403.

2. Section 65.1 is revised to read as follows:

§ 65.1 Application of Part 65.

This part establishes procedures and methodologies for Commission prescription of interstate rates of return. This part shall apply to those interstate services and carriers as the Commission shall designate by order. This part shall not apply to dominant interexchange carriers subject to §§ 61.41 through 61.49, except as set forth in §§ 65.600(c), 65.701(c) and 65.703(g). Local exchange carriers subject to §§ 61.41 through 61.49 are exempt from the requirements of this part, with the following exceptions: (1) carriers that meet the requirements of § 65.200(b) shall be subject to the filing requirements of Subpart C of this part; (2) carriers subject to §§ 61.41 through 61.49 shall employ the rate of return value calculated for the LEC industry in complying with any applicable rules under Parts 36 and 69 that require a return component; and (3) carriers subject to §§ 61.41 through 61.49 shall be subject to §§ 65.600(d), 65.701(c), and 65.703(g).

3. Section 65.600 is amended by revising paragraph (b) and adding new paragraph (d), as follows:

§ 65.600. Rate of return reports.

(a) * * *

(b) Each local exchange carrier or group of affiliated carriers which is not subject to §§ 61.41 through 61.49 and which has filed individual access tariffs during the preceding enforcement period shall file with the Commission within three (3) months after the end of each calendar quarter, a quarterly rate of return monitoring report. Each report shall contain two parts. The first part shall contain rate of return information on a cumulative basis from the start of the enforcement period through the end of the quarter being reported. The second part shall contain similar information for the most recent quarter. The final quarterly monitoring report for the entire enforcement period shall be considered the enforcement period report. Reports shall be filed on the appropriate report form prescribed by the Commission (see § 1.795 of this chapter) and shall provide full and specific answers to all questions propounded and information requested in the currently effective report form. The number of copies to be filed shall be specified in the applicable report form. At least one copy of the report shall be signed

on the signature page by the responsible officer. A copy of each report shall be retained in the principal office of the respondent and shall be filed in such manner as to be readily available for reference and inspection. Final adjustments to the enforcement period report shall be made by September 30 of the year following the enforcement period to ensure that any refunds can be properly reflected in an annual access filing. For local exchange carriers subject to §§ 61.41 through 61.49, final adjustments to the final enforcement period report covering the period ending June 30, 1990, shall be made no later than April 1, 1991.

(c) * * *

(d) Each local exchange carrier or group of affiliated carriers subject to §§ 61.41 through 61.49 shall file with the Commission within three (3) months after the end of each calendar year a report of its total interstate access rate of return for that year. Such filings shall include a report of the total revenues, total expenses and taxes, operating income, and the rate base. A copy of each report shall be retained in the principal office of the respondent and shall be filed in such manner as to be readily available for reference and inspection.

4. Section 65.701 is amended by adding paragraph (d) as follows:

§ 65.701 Period of Review.

* * * * *

(d) Notwithstanding other provisions in this subpart, the final period of review for any local exchange carrier subject to §§ 61.41 through 61.49 shall end on June 30, 1990.

5. Section 65.703 is amended by revising paragraph (g) and by adding new paragraph (h) as follows:

§ 65.703 Refunds.

(a) * * *

(b) * * *

(c) * * *

(d) * * *

(e) * * *

(f) * * *

(g) For interexchange carriers subject to §§ 61.41 through 61.49, * * * * *

(h) For each local exchange carrier subject to §§ 61.41 through 61.49, refund obligations incurred prior to the end of its final period of review shall be effectuated by an adjustment to the applicable Actual Price Index, Service Band Index, and Price Cap Index (as defined in § 61.3). Carriers making an adjustment to effectuate any outstanding refund requirements from their final enforcement period shall make such adjustments no later than during the next scheduled annual price cap adjustment tariff filing following the submission of the final enforcement report. The adjustment shall be designed to complete the required refund within 12 months, following which the Actual Price Index, the Service Band Index, or the Price Cap Index shall be adjusted to remove the effect of the adjustment.

PART 69 -- ACCESS CHARGES

1. The authority citation for Part 69 continues to read as follows:

Authority: Secs 4, 201, 202, 203, 205, 218, 403, 48 Stat. 1066, 1070, 1072, 1077, 1094, as amended, 47 U.S.C. 154, 201, 202, 203, 205, 218, 403, unless otherwise noted.

2. Section 69.1 is amended by adding paragraph (c), as follows:

§ 69.1 Application of access charges.

* * * * *

(c) The following provisions of this part shall apply to telephone companies subject to price cap regulation only to the extent that they are necessary to develop the nationwide average carrier common line charge: §§ 69.3(f), 69.103(b), 69.105(b)(4), 69.105(b)(5), 69.106(b), 69.107(b), 69.107(c), 69.109(b), 69.111(c), 69.112(a), 69.112(b)(2), 69.112(b)(3), 69.112(d)(2), 69.112(d)(3), 69.114(b), 69.114(d), 69.205(e), 69.301 through 69.310, and 69.401 through 69.412.

3. Section 69.3 is amended by revising paragraphs (a) and (e)(4), and by adding a new paragraph (g) as follows:

§ 69.3 Filing of access service tariffs.

(a) Except as provided in paragraphs (f) and (g), a tariff for access service shall be filed with this Commission for an annual period. Such tariffs shall be filed on a minimum of 90 days' notice with a scheduled effective date of July 1. Such tariff filings shall be limited to rate level changes.

* * * * *

(e) * * *

(4) Except for charges subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, any charge in such a tariff that is not an association charge must be computed to reflect the combined investment and expenses of all companies that participate in such a charge;

* * * * *

(g) Local exchange carriers subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, shall file with this Commission a price cap tariff for access service for an annual period. Such tariffs shall be filed to provide a minimum of 90 days' notice with a scheduled effective

date of July 1. Such tariff filings shall be limited to changes in the Price Cap Indexes, rate level changes (with corresponding adjustments to the affected Actual Price Indexes and Service Band Indexes), and the incorporation of new services into the affected indexes as required by § 61.49.

4. Sec. 69.101 is revised to read as follows:

§ 69.101 General.

Except as provided in § 69.1 and Subpart C of this part, charges for each access element shall be computed and assessed as provided in this subpart.

5. Sec. 69.105 is amended by adding paragraphs (b)(7) and (b)(8), as follows:

§ 69.105 Carrier Common Line.

* * * * *

(b) * * *

(7) The Carrier Common Line charges of telephone companies that are subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, shall be computed at the level of Carrier Common Line access element aggregation selected by such telephone companies pursuant to § 69.3(e)(7). For each such Carrier Common Line access element tariff, the premium originating Carrier Common Line charge shall be one cent per minute. The premium terminating Carrier Common Line charge shall be set at a level that, when aggregated with the one cent originating charge, shall not cause the Actual Price Index for the common line basket to exceed the Price Cap Index for that basket.

(8) If the calculations described in subparagraph (b)(7) of this section result in a per minute charge on premium terminating minutes that is less than one cent, the originating and terminating charges shall be equal, and set at a level that does not cause the API for the common line basket to exceed the PCI.

* * * * *

6. Section 69.111(a) is revised to read as follows:

§ 69.111 Common transport.

(a) A charge that is expressed in dollars and cents per access minute shall be assessed upon all interexchange carriers that use switching or transmission facilities that are apportioned to the Common Transport element for purposes of apportioning investment, or that are equivalent to those

facilities for companies subject to price cap regulation as that term is defined in § 61.3(v) of this chapter.

7. Section 69.113(c) is revised to read as follows:

§ 69.113 Non-Premium Charges for MTS-WATS Equivalent Services.

* * * * *

(c) For telephone companies that are not price cap carriers, the non-premium charge for the Local Switching element shall be computed by multiplying a hypothetical premium charge for such element by .45. The hypothetical premium charge for such element shall be computed by dividing the annual revenue requirement for each element by the sum of the projected access minutes for such element for such period and a number that is computed by multiplying the projected non-premium minutes for such element for such period by .45. For telephone companies that are price cap carriers, the non-premium charge for the Local Switching element shall be computed by multiplying the premium charge for such element by .45. Through December 31, 1992, the non-premium charge shall be computed by multiplying the LS1 charge for such element by .45.

8. Section 69.114(a) is revised to read as follows:

§ 69.114(a) Special access.

(a) Appropriate subelements shall be established for the use of equipment or facilities that are assigned to the Special Access element for purposes of apportioning net investment, or that are equivalent to such equipment or facilities for companies subject to price cap regulation as that term is defined in § 61.3(v) of this chapter.

9. Section 69.205(c) is revised to read as follows:

§ 69.205 Transitional premium charges.

* * * * *

(c) Except for telephone companies subject to price cap regulation, as that term is defined in § 61.3(v) of this chapter, the charge for an LS2 premium access minute shall be computed by dividing the premium Local Switching revenue requirement by the sum of the projected LS2 premium access minutes and a number that is computed by multiplying the projected LS1 premium access minutes by the applicable LS1 transition factor. For all telephone companies, the charge for an LS1 premium access minute shall be computed by multiplying the charge for an LS2 premium minute by the applicable LS1 transition factor. For telephone companies that are not price cap carriers, the premium Local Switching revenue requirement shall be computed by

subtracting the projected revenues from non-premium charges attributable to the Local Switching element from the revenue requirement for each element.

10. Section 69.301(a) is revised to read as follows:

§ 69.301 General.

(a) For telephone companies that are not subject to price cap regulation as that term is defined in § 61.3(v) of this chapter, for purposes of computing annual revenue requirements for access elements, net investment as defined in § 69.2(z) shall be apportioned among the interexchange category, the billing and collection category, and access elements as provided in this Subpart. Expenses shall be apportioned as provided in Subpart E of this Part. For telephone companies that are price cap carriers, for purposes of calculating annual revenue requirements for access elements, net investment shall be apportioned between common line and all other interstate services. Expenses shall also be apportioned between common line and all other interstate services.

11. Section 69.302(b) is revised to read as follows:

§ 69.302 Net investment.

* * * * *

(b) Except as provided in § 69.301(a), investment in Accounts 2002, 2003, and, to the extent inclusions are allowed by this Commission, Account 2005, shall be apportioned on the basis of total investment in Account 2001, Telecommunications Plant in Service. * * *

12. Section 69.303 is revised to read as follows:

§ 69.303 Information Origination/Termination Equipment (IOT).

(a) Except as provided in § 69.301(a), investment in public telephones and appurtenances shall be assigned to the Common Line element, if capable of use with the services of more than one interexchange carrier, or the Limited Pay Telephone element, if capable of use with the services of only one interexchange carrier.

(b) Except as provided in § 69.301(a), investment in all other IOT shall be apportioned between the Special Access and Common Line elements on the basis of the relative number of equivalent lines in use, as provided herein. * * *

13. Section 69.304 is revised to read as follows:

§ 69.304 Subscriber line cable and wire facilities.

* * * * *

(b) Except as provided in § 69.301(a), investment in interstate and foreign private lines and interstate WATS access lines shall be assigned to the Special Access element.

(c) Except as provided in § 69.301(a), investment in lines terminating in public telephones which may only access the services of one interexchange carrier (or partnership) shall be assigned to the Limited Pay Telephone element. * * *

14. Section 69.305 is revised to read as follows:

§ 69.305 Carrier cable and wire facilities (C&WF).

(a) Except as provided in § 69.301(a), Carrier C&WF that is not used for "origination" or "termination" as defined in § 69.2(bb) and § 69.2(cc) shall be assigned to the interexchange category.

(b) Except as provided in § 69.301(a), Carrier C&WF, other than WATS access lines, not assigned pursuant to paragraph (a) of this section that is used for interexchange services that use switching facilities for origination and termination that are also used for local exchange telephone service shall be apportioned between the Dedicated Transport and Common Transport elements. * * *

(c) Except as provided in § 69.301(a), all Carrier C&WF that is not apportioned pursuant to paragraphs (a) and (b) of this section shall be assigned to the Special Access element.

15. Section 69.306 is revised to read as follows:

§ 69.306 Central office equipment (COE).

(a) Except as provided in § 69.301(a), the Separations Manual cateogries shall be used for purposes of apportioning investment in such equipment except that any Central office equipment attributable to a Dedicated Transport subelement shall be assigned to the Dedicated Transport element.

(b) Except as provided in § 69.301(a), COE Category 1 (Operator Systems Equipment) shall be apportioned among the interexchange category and the access elements as follows: Category 1 that is used for intercept services shall be assigned to the Local Switching element. * * *

(c) Except as provided in § 69.301(a), COE Category 2 (Tandem Switching equipment) that is deemed to be exchange equipment for purposes of the Modification of Final Judgment in United States v. Western Electric Co. shall be assigned to the Common Transport element. * * *

(d) Except as provided in § 69.301(a), COE Category 4 (Circuit Equipment) shall be apportioned among the interexchange category and the Common Line, Limited Pay Telephone, Dedicated Transport, Common Transport, and Special Access elements. * * *

16. Section 69.307 is revised to read as follows:

§ 69.307 General support facilities.

Except as provided in § 69.301(a), General Support Facilities investments shall be apportioned among the interexchange category, the billing and collection category, and Common Line, Limited Pay Telephone, Local Switching, Information, Dedicated Transport, Common Transport, and Special Access elements on the basis of Central Office Equipment, Information Origination/Termination Equipment, and Cable and Wire Facilities excluding Category 1.3, combined.

17. Section 69.308 is revised to read as follows:

§ 69.308 Equal access equipment.

Except as provided in § 69.301(a), Equal Access investment shall be assigned to the Local Switching element unless the telephone company chooses to implement a separate Equal Access element as provided in paragraph 69.4(d), in which case Equal Access investment shall be assigned to the Equal Access element.

18. Section 69.309 is revised to read as follows:

§ 69.309 Other investment.

Except as provided in § 69.301(a), investment that is not apportioned pursuant to §§ 69.302 through 69.308 shall be apportioned among the interexchange category, the billing and collection category, and access elements in the same proportions as the combined investment that is apportioned pursuant to §§ 69.303 through 69.308.

19. Section 69.310 is revised to read as follows:

§ 69.310 Capital Leases.

Except as provided in § 69.301(a), Capital Leases in Account 2680 shall be directly assigned to the appropriate interexchange category or access elements consistent with the treatment prescribed for similar plant costs or shall be apportioned in the same manner as Account 2001.

20. Section 69.401 is revised to read as follows:

§ 69.401 Direct expenses.

(a) Except as provided in § 69.301(a), Plant Specific Operations Expenses in Accounts 6110 and 6120 shall be apportioned among the interexchange category, the billing and collection category and appropriate access elements on the following basis:

* * * * *

(b) Except as provided in § 69.301(a), Plant Specific Operations Expenses in accounts 6210, 6220, and 6230 shall be apportioned among the interexchange category and access elements on the basis of the apportionment of the total COE investment.

(c) Except as provided in § 69.301(a), Plant Specific Operations Expenses in Accounts 6310 and 6410 shall be assigned to the appropriate investment category and shall be apportioned among the interexchange category and access elements in the same proportions as the total associated investment.

(d) Except as provided in § 69.301(a), Plant Non Specific Operations Expenses in Accounts 6510 and 6530 shall be apportioned among the interexchange category, the billing and collection category, and access elements in the same proportions as the combined investment in COE, IOT, and C&WF apportioned to each element and category.

(e) Except as provided in § 69.301(a), Plant Non Specific Operations Expenses in Account 6540 shall be be assigned to the interexchange category.

(f) Except as provided in § 69.301(a), Plant Non Specific Operations Expenses in Account 6560 shall be apportioned among the interexchange category, the billing and collection category, and access elements in the same proportion as the associated investment.

(g) Except as provided in § 69.301(a), amortization of embedded customer premises wiring investment shall be deemed to be associated with § 69.303(b) IOT investment for purposes of the apportionment described in paragraph (c) of this section.

21. Section 69.402 is revised to read as follows:

§ 69.402 Operating taxes (Account 7200).

(a) Except as provided in § 69.301(a), federal income taxes, state and local income taxes, state and local gross receipts or gross earnings taxes that are collected in lieu of a corporate income tax shall be apportioned among the interexchange category, the billing and collection category and all access elements based on the approximate net taxable income on which the tax is levied (positive or negative) applicable to each element and category.

(b) Except as provided in § 69.301(a), all other operating taxes shall be apportioned among the interexchange category, the billing and collection category and all access elements in the same manner as the investment apportioned to each element and category pursuant to § 69.309 Other Investment.

22. Section 69.403 is revised to read as follows:

§ 69.403 Marketing expense (Account 6610).

Except as provided in § 69.301(a), Marketing expense shall be apportioned among the interxchange category and all access elements in the same proportions as the combined investment that is apportioned pursuant to { 69.309.

23. Section 69.404 is revised to read as follows:

§ 69.404 Telephone operator services expenses in Account 6620.

Except as provided in § 69.301(a), telephone operator services expenses shall be apportioned among the interexchange category, and the Local Switching and Information elements based on the relative number of weighted standard work seconds. * * *

24. Section 69.405 is revised to read as follows:

§ 69.405 Published directory expenses in Account 6620.

Except as provided in § 69.301(a), Published Directory expenses shall be assigned to the Information element.

25. Section 69.406 is revised to read as follows:

§ 69.406 Local business office expenses in Account 6620.

(a) Except as provided in § 69.301(a), Local business office expenses shall be assigned as follows: * * *

26. Section 69.407 is revised to read as follows:

§ 69.407 Revenue Accounting expenses in Account 6620.

* * * * *

(b) Except as provided in § 69.301(a), Revenue Accounting Expenses that are attributable to carrier's carrier access billing and collection expense shall be apportioned among all carrier's carrier access elements except the Common Line element. * * *

(c) Except as provided in § 69.301(a), all other Revenue Accounting Expenses shall be assigned to the billing and collection category.

27. Section 69.408 is revised to read as follows:

§ 69.408 All other customer services expense in Account 6620.

Except as provided in § 69.301(a), all other customer services expenses shall be apportioned among the interexchange category, the billing and collection category, and all access elements based on the combined expenses in §§ 69.403 through 69.407.

28. Section 69.409 is revised to read as follows:

§ 69.409 Corporate operations expenses (Accounts 6710 and 6720).

Except as provided in § 69.301(a), all corporate operations expenses shall be apportioned among the interexchange category, the billing and collection category and all access elements in accordance with the Big 3 Expense Factor as defined in § 69.2(f).

29. Section 69.410 is revised to read as follows:

§ 69.410 Equal access expenses.

Except as provided in § 69.301(a), Equal Access expenses shall be assigned to the Local Switching element unless the telephone company chooses to implement a separate Equal Access element as provided in paragraph 69.4(d), in which case Equal Access expenses shall be assigned to the Equal Access element.

30. Section 69.411 is revised to read as follows:

§ 69.411 Other expenses.

Except as provided in §§ 69.301(a), 69.412, 69.413, and 69.414, expenses that are not apportioned pursuant to §§ 69.401 through 69.410 shall be approtioned among the interexchange category and all access elements in the same manner as § 69.309 Other investment.

APPENDIX E

ANALYSIS OF RECORD EVIDENCE OF
LECS' POST-DIVESTITURE INTERSTATE PRODUCTIVITY

This Commission's evaluation of a range of productivity data in the record leads us to conclude that the best estimate of potential annual productivity gain in the telecommunications industry is 2.5 percent over and above the level achieved by the economy as a whole. In reaching this conclusion, we rely principally on long time series productivity data.[1] We also attempt to corroborate these data, which relate to unified, pre-divestiture Bell System operations, by analyzing price and cost data from the post-divestiture period (1984-88) -- a period during which AT&T and the RBOCs operated on an independent basis -- in order to infer productivity using those data. This corroboration methodology is based on the simple and well recognized principle that a duality exists between cost and production functions; that is, the existence of one function implies the existence of the other. It is possible, therefore, to calculate a change in total factor productivity, which is a measure of the change in a production function, by calculating a change in the cost function.[2] Changes in the cost function of a regulated industry can be inferred from changes in observed prices because regulation ensures that prices closely track costs.

In the Further Notice, our application of the principle of the duality of cost functions and production functions to AT&T's rates during the period from 1984 through 1988 yielded a total factor productivity calculation for this period of 2.48 percent, corroborating our long term estimate of 2.5 percent for the industry as a whole.[3] In this Order, we re-analyze our earlier calculations, and comments thereon, and arrive at essentially the same conclusion for AT&T.[4]

---

1 For a discussion of the propriety of relying on long time series productivity data, see especially Section III.C.1.b, supra.

2 For a concise but comprehensive discussion and proof of the duality of cost and production functions, see E. Silberberg, The Structure of Economics (1978), at 309-13.

3 Further Notice, 3 FCC Rcd at Appendix C.

4 See Section III.C.1.b.iii; Appendix C.

The task of estimating productivity from price data is considerably more complex with regard to the LECs than it is for AT&T. This is because changes in exogenous costs must be netted from the price changes under examination, and the LECs experienced far more changes of this nature during the 1984-88 period than did AT&T. Because we did not possess data sufficiently conprehensive to permit us to account for all of these changes, we could not include in the Further Notice an estimate of recent LEC productivity based on observed price changes. We did, however, request the LECs to supply data, to perform such an analysis for the LEC industry as a whole, and to disaggregate the industry-wide calculation into individual RBOC results in order to clarify whether productivity differed among individual companies on a sustained basis.

The current record contains several studies submitted by Bellcore which purport to demonstrate that productivity achieved by the LEC industry during the post-divestiture period generally was several percentage points lower than the 2.5 percent long run estimate contained in the Further Notice (Bellcore Studies).[5] These demonstrations were contested strongly by non-LEC commenters, some of whom provided their own interpretations of LEC-supplied data, interpretations that yielded productivity calculations much higher than our 2.5 percent estimate. One of the most comprehensive critiques of the Bellcore Studies was filed by AT&T (AT&T Study).[6]

For the most part, these studies share a common foundation in that they are based on a price analysis of LEC rates during the post-divestiture period. As noted previously, however, this kind of analysis requires that certain exogenous cost changes be netted out of price changes in order that productivity may be inferred accurately from the adjusted prices. Even a casual examination of the Bellcore studies, and AT&T's critique of those studies, reveals that each party has made significantly different assumptions

---

5 Bellcore, "The Impact of Federal Price Cap Regulation on Interstate Toll Customers," March 17, 1988 (March 17 Bellcore Study); Southwestern Bell Telephone, "Technical Appendix to the March 17, 1988 Bellcore Study," March 25, 1988 (March 25 Technical Appendix); Bellcore, "The Impact of the FCC Proposed Price Cap Plan on Interstate Consumers," August 18, 1988 (Supplemental Comments of Southwestern Bell Telephone) (August 18 Bellcore Study); Bellcore, "The Impact of the FCC Proposed Price Cap Plan on Interstate Consumers - Regional Disaggregation," September 8, 1988 (September 8 Bellcore Study); Bellcore, "Analysis of AT&T's Reply Comments" (Bellcore Reply), November 18, 1988 letter from Dana Rasmussen, US West, to Secretary, Federal Communications Commission (written ex parte presentation).

6 "Analysis of the Bellcore Study", AT&T Reply, Attachment C, September 9, 1988 (AT&T Study).

about whether and how to net out the effects of the numerous exogenous cost changes that affected LECs during the post-divestiture period. Our analysis of these assumptions reveals that Bellcore's estimate of approximately zero productivity for LECs during the 1984-88 period would increase by two or three percentage points if only major errors in its assumptions were corrected. Correcting AT&T's critique would cause its estimate of approximately 7 percent productivity to fall in a similar fashion.

As discussed in detail below, we conclude that important errors or uncertainties in the studies' methods undercut the reliability of the conclusions in these studies about the LECs' post-divestiture interstate productivity. Moreover, as explained more fully below, it is not obvious that that the most important methodological problems with these studies can be overcome.

Some of the most important problems with the studies' methods are as follows: (1) Bellcore incorrectly estimates exogenous costs associated with the CPE phase-down and the amortization of inside wire; (2) Bellcore incorrectly treats costs associated with the information access element and the Universal Service Fund; (3) the parties do not calculate the effect on switched access rates of equal access conversions and the migration of non-premium to premium minutes of use; (4) the parties' conflicting views concerning the effect on total interstate productivity of WATS direct assignment cannot be resolved with certainty; and (5) Bellcore's method of estimating special access productivity is seriously flawed. We turn now to an examination of these problems.

(1) Bellcore incorrectly estimates exogenous costs associated with the CPE phase-down and the amortization of inside wire. Bellcore's estimate of the total difference between the CPE phased-down amount included in the the rates which became effective on May 25, 1984 (the beginning point of the study) and the amount included in the rates which became effective on January 1, 1988 (the ending point of the study) is $657 million.[7] The correct estimate of the difference is at least $1,094 million,[8] which differs

---

7 March 25 Technical Appendix at A.4.

8 $1,094 million is the CPE phased-down amount for Tier 1 LECs only. See "Commission Incorporates Certain Data in Price Cap Proceeding Record," Public Notice, DA 88-178, released Nov. 17, 1988 (Supplemental Data); see also Investigation of Access and Divestiture /Related Tariffs, CC Docket No. 83-1145, Phase I and MTS and WATS Market Structure, CC Docket No. 78-72, Phase I, Memorandum Opinion and Order, FCC 84-201, released May 15, 1984 (May 15, 1984 Order) Appendix A, Table 9 and Appendix B, line 9.

from Bellcore's estimate by $437 million. Correction of this error tends to lower Bellcore's estimate of productivity for switched access.

Bellcore's estimate of the total difference between the inside wire revenue requirement included in the switched access rates effective May 25, 1984 and the amount included in the rates effective January 1, 1988 is $616 million.[9] The Supplemental Data, provided by the Tier 1 LECs and NECA at the Commission's request, demonstrates that inside wire cost data used in the Bellcore Studies is significantly flawed. During the June 1984 - May 1985 period, actual inside wire costs were $1,373 million for the Tier 1 LECs. Projected 1988 inside wire costs for the Tier 1 LECs (on a Part 32 basis) are $1,252 million.[10] Therefore, the total difference between the 1984-85 and 1988 inside wire revenue requirement is only $121 million, $495 million less than Bellcore's measurement. Correction of this error tends to increase Bellcore's estimate of productivity for switched access.

(2) Bellcore incorrectly treats costs associated with the information access element and the Universal Service Fund. Bellcore excludes the revenue requirement for the information access element in calculating the switched access rates for the 1984 base period.[11] In calculating the 1988 rates, however, Bellcore inconsistently includes the revenue requirement for the information access element.[12] Bellcore should have removed $393 million, the amount of the 1988 revenue requirement for the information access element, from the 1988 rates.[13] Correction of this error tends to increase Bellcore's estimate of productivity for switched access.

Bellcore incorrectly neglects to remove the Universal Service Fund amount of $184 million[14] from the 1988 common line revenue requirement.

---

9 March 25 Technical Appendix at A.4.

10 1988 Tier 1 Tariff Review Plan (TRP) Rollup, Nov. 12, 1987, Chart COS-2(P)32.

11 March 25 Technical Appendix at I.A; see also May 15, 1984 Order at para. 78.

12 March 25 Technical Appendix at A.2.

13 See 1988 Tier 1 TRP Rollup, Chart COS-2 (P) 31 and the 1988 Tier 2A TRP Rollup, Nov. 17, 1987, Chart T2ACOS-2(P) 31.

14 NECA, 1988 Annual Access Tariff Filing Cost Support, Oct. 2, 1987, Volume 3, pp. 3-2-12,13.

Correction of this error tends to increase Bellcore's estimate of productivity for switched access.

(3) The parties do not calculate the effect on switched access rates of equal access conversions and the migration of non-premium to premium minutes of use. Neither Bellcore nor AT&T calculates the effect on switched access rates of equal access conversions and non-premium minutes of use (MOU) migration, although these events are among the most important in the LEC industry during the post-divestiture period. Such a calculation is theoretically complex. It requires the resolution of many issues which have been the subject of considerable controversy in past proceedings. Nevertheless, incorporation of the impact of equal access conversions and non-premium MOU migration could considerably change Bellcore's estimate of productivity. Three aspects of this issue need to be addressed. First, costs defined as equal access by the FCC should be removed from rate calculations. The FCC has permitted the inclusion of certain equal access costs in the interstate access rate base. The Supplemental Data demonstrates that in 1984-85, these costs were $47 million. For 1988, these costs were projected by the LECs to be $255 million.[15] Removal of these costs from the revenue requirements for 1984-85 and 1988 tends to increase Bellcore's estimate of productivity for switched access.

Second, proper estimation of productivity may require the removal of significant equal access costs that are not captured by the removal of the amounts identified above. The Commission defined certain costs as "equal access" for the purpose of permitting LECs to amortize these costs.[16] The resulting definition of equal access costs is a very strict one. Although the Commission adopted a strict definition of equal access costs that are subject to amortization, such a definition may not be appropriate for analysis of productivity. It is likely that there significant equal access costs that are not captured by the strict definition. Therefore, in addition to removing the equal access costs identified above, it may be important to remove equal access costs of a significant, yet unknown, quantity. Defining and measuring these costs would not be a trivial undertaking, nor is it obvious that sufficient data exist to make such determinations with precision.

Third, proper estimation of productivity may require adjustment for further cost effects of the migration of non-premium MOU. The migration of non-premium MOU may have significantly altered switching costs aside from

---

15 1988 Tier 1 TRPs, Chart COS-7.

16 See Petitions for Recovery of Equal Access and Network Reconfiguration Costs, Memorandum Opinion and Order, FCC 85-628, released Sept. 9, 1985, at 18 ff.

requiring the provision of equal access facilities. On one hand, non-premium messages may transit local switches more often than premium messages. On the other hand, non-premium messages may not utilize as many switching features as premium messages. It is, therefore, unclear whether premium or non-premium service is more expensive for LECs to provide. It is also unclear by what magnitude the cost of providing one kind of service differs from the other. The answers to these questions are important for evaluating productivity in the post-divestiture period because the amount of non-premium migration has been large[17] and represents a unique occurrence for which appropriate cost adjustment should be made. Unfortunately, comparison of premium and non-premium switching costs may not be feasible, due to the complexity of the issue and the lack of relevant data.

(4) The parties' conflicting views concerning the effect on total interstate productivity of WATS direct assignment cannot be resolved with certainty. AT&T alleges that Bellcore has seriously underestimated productivity for switched access by incorrectly estimating the effect of the direct assignment of closed-end WATS lines to the special access category, beginning in June 1986. AT&T asserts that proper treatment requires removal of both WATS closed-end costs and WATS closed-end minutes of use (MOU) from computation of the common line rate and alleges that Bellcore has removed only the costs. AT&T asserts that correction of the alleged Bellcore error increases the estimate of switched access productivity by 2.57 percent.[18]

Bellcore replies that its treatment of WATS direct assignment is correct and that AT&T's analysis is flawed.[19] Bellcore argues that AT&T's analysis ignores the effect of WATS direct assignment on special access rates and further argues that correction of switched access rates for the WATS demand shift requires an equal but opposite correction of special access rates. Bellcore argues that the WATS demand shift has a neutral impact on interstate access rates as a whole. Bellcore asserts that the net effect of direct assignment of WATS on aggregate interstate access rates is a shift of $170 million in costs from the state jurisdiction to the interstate jurisdiction

---

17 In July 1984, which is a representative month for the beginning of the post-divestiture period, approximately 14 percent of interstate common line traffic was non-premium. By 1988, LECs projected that non-premium interstate common-line traffic would dwindle between 3 and 4 percent. See 1988 Tier 1 TRP Rollup, Chart DMD-1. Hence, a large amount of traffic has migrated from non-premium to premium service.

18 AT&T Study at 9.

19 Bellcore Reply at 3-7.

pursuant to Part 67 of the Rules.[20] Bellcore states that it did not attempt to quantify the effect of the WATS demand shift on the switched and special access rates separately, for two reasons: (1) the WATS demand shift does not affect the estimate of productivity for aggregate interstate access, which is the only estimate at issue in the FCC price cap plan; and (2) disaggregate quantification is conceptually difficult.

Although the arguments presented by the parties are complex, it is possible to make definite findings regarding their reasonableness. First, AT&T is correct in pointing out that Bellcore substantially underestimates switched access productivity by ignoring the effect of the WATS demand shift on switched access rates. WATS loops carry a much higher concentration of traffic than ordinary subscriber lines. Elimination of WATS costs and demand from the common line access element reduces demand proportionally more than costs. WATS direct assignment, therefore, increases common line rates. As AT&T claims, adjustment of rates for the WATS demand shift tends to increase dramatically Bellcore's estimate of switched access productivity.

Second, Bellcore is incorrect in arguing that the effect of the WATS demand shift on switched access rates must necessarily be offset by an equal but opposite effect on special access rates. Consider the following simplified example. Assume that special access rates are applied exclusively to loops, rather than a combination of channel terminations, channel mileage and optional features and functions, as actually occurs. Assume further that only voice grade lines are provided under the special access tariff. As explained above, the removal of WATS loops, which are characterized by high usage, from the common line access element increases common line rates. The inclusion of WATS loops in the special access element, however, has no impact on special access rates. This result follows from the fact that the Commission's separations rules require that the cost of voice grade special access loops and the cost of WATS loops be indentical.[21] Because the inclusion of WATS lines in the special access element increases both costs and demand (i.e., loops) in equal proportions, special access rates remain the same. Bellcore's claim that the WATS demand shift must be neutral in aggregate is incorrect.

The reason that Bellcore's adjustment for the WATS demand shift lowers the estimate of special access productivity is that Bellcore has unwisely chosen channel terminations (CT) as the unit of demand by which productivity is measured. Although the cost of a WATS loop equals the cost of a voice

---

20 Bellcore Reply at 3.

21 See Section 36.154(a) and (b) of this Commission's Rules, 47 C.F.R. § 36.154 (a) and (b).

grade special access loop, the unit cost of a WATS channel termination does not equal the unit cost of a voice grade special access channel termination, for several reasons: (1) a WATS line has only a single CT, whereas a voice grade special access line has at least 2, thereby tending to increase the unit cost of a WATS CT;[22] (2) a WATS line has substantially less channel mileage than a voice grade special access line and, as a result, tends to be cheaper;[23] and (3) a WATS loop is usually 2-wire and is, therefore, half as expensive as the typical voice grade special access loop, which is 4-wire;[24] Overall, WATS CTs are cheaper than voice grade special access CTs. Therefore, the adjustment of special access rates by removing WATS CTs from special access tends to raise special access rates and to lower the estimate of special access productivity. However, as we show in section (5) below, CTs are an inappropriate unit of demand by which to measure special access productivity. Use of CTs likely results in erroneous measurement of productivity. Thus, the fact that adjustment of special access CT rates for the WATS demand shift reduces Bellcore's measure of special access productivity does not imply that special access productivity would be reduced if measured using a more appropriate unit of demand. Unfortunately, correct adjustment of special access rates for the WATS demand shift cannot be accomplished without completely revising the Bellcore special access productivity study.

(5). Bellcore's method of estimating special access productivity is seriously flawed. In using CTs to compare 1988 special access rates with 1985 special access rates, Bellcore fails to adjust appropriately for the effect of important trends. The market characteristics of special access service have changed dramatically during the post-divestiture period. Since divestiture, there have been important shifts in demand for various access services. One example is the shift in the proportion of 2-wire CTs (excluding WATS) to total (2-wire and 4-wire) CTs (excluding WATS) from 1985 to 1988. In the December 3, 1983 Access Tariff Filing,[25] NECA forecast 480,000 2-

---

22 WATS lines are switched to an AT&T point of presence and are, therefore, charged switched access on the Interstate Carrier's end, rather than a channel termination charge.

23 As explained in section (5), below, Bellcore calculates channel termination costs based on the total special access revenue requirement, including channel mileage costs.

24 Separation procedures require that loop costs be allocated on the basis of equivalent 2-wire loops. A 4-wire loop is equivalent to two 2-wire loops and is allocated twice as much cost.

25 NECA Special Access Tariff Filing, December 3, 1984, Description and

wire telegraph and voice grade CTs and 875,000 4-wire telegraph and voice grade CTs. The 2-wire CTs were, therefore, 35 percent of the total.[26] NECA's forecast is the basis for its special access rates which became effective in 1985 and which Bellcore adopts as the beginning point in its analysis of special access productivity. In the 1988 annual access tariff filings, the Tier 1 LECs forecast 343,000 2-wire telegraph and voice grade CTs and 1,501,000 4-wire telegraph and voice grade CTs.[27] The 2-wire CTs were, therefore, 19 percent of the total. The Tier 1 LECs' 1988 forecast is the basis for the special access rates which became effective in 1988 and which Bellcore adopts as the ending point in its analysis of special access productivity. Thus, the 2-wire composition of an "average" special access CT decreased significantly from 1985 to 1988. In accordance with standard separations practices, all loops of voice grade quality or lower are measured as equivalent 2-wire loops for the purpose of cost assignment. Hence, the cost assigned to a 4-wire loop is twice that assigned to a 2-wire loop. Therefore, the decrease in the proportion of 2-wire CTs tends to raise the 1988 special access revenue requirement. If the 1988 special access revenue requirement were appropriately adjusted to reflect the same 2-wire composition of CTs as in the 1985 revenue requirement, i.e., if the units of demand by which productivity is measured were kept the same over the period, 1988 special access rates would decrease and the Bellcore estimate of special access productivity would increase.

Similar analyses apply to other relationships that are subject to change over time, such as the proportion of CT costs to total special access costs[28]

Justification, Volume 1, Figure 4-15 (December 3, 1984 Access Tariff Filing).

26 The forecasts in the December 3, 1984 Access Tariff Filing were seriously flawed. See NECA's Direct Case in CC Docket 85-166, Phase II, Part 1, Feb. 21, 1986, Table 3; see also Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166, Phase II, Part 1, Memorandum Opinion and Order, Mimeo 2057, released Jan. 17, 1986. Using a slightly different measure of 2- and 4-wire CTs than above, NECA provided data which demonstrated that the actual proportion of 2-wire CTs in September, 1985 was 25 percent of the total, whereas the forecast proportion of 2-wire CTs in the December 3, 1984 Access Tariff Filing, on which were based rates that were effective in September, 1985, was 40 percent.

27 The 1988 Tier 1 Rollup, Chart DMD4.

28 The August 18 Bellcore Study computes special access rates by dividing total special access costs (i.e., the costs of channel terminations, channel mileage and optional features and functions) by channel terminations. August 18 Bellcore Study at 25-26. See also Tier 1 1988 TRP Rollup, Chart COS-2(P)32. The estimate of special access productivity may be biased to the extent that the proportion of channel termination costs to total special

and the ratio of CTs to loops.[29] As a result of Bellcore's failure to analyze these and other relationships, Bellcore's estimate of special access productivity is unreliable.

Our analysis of these five flaws in the parties' productivity studies demonstrates that their estimates of interstate access productivity in the post-divestiture period are, on their face, unreliable. The aggregate result of this analysis indicates that correct estimates would exceed Bellcore's estimates for both switched and special access.

It is also important to note that the five issues reviewed above are not the only flaws in these studies. For example, the parties take different and irreconcilable positions on the issue of whether rates during the 1984-88 period should be adjusted for under- or over-earnings, and it is not obvious which position is most appropriate.

Of course, this analysis represents only our tentative conclusions about the studies in general and the particular issues discussed above. It illustrates the difficulty of attempting a price/cost analysis of a period marked by many major changes in regulation. We welcome comment on our analysis. We also seek additional data that might assist us in refining our examination of post-divestiture LEC productivity.

---

access costs change over time.

29 Changes in special access costs per CT are related to changes in the ratio of CTs to loops. As the ratio declines, costs per CT rise.

APPENDIX F

DERIVATION OF CCL FORMULA

Let C = base period cost per line

M = base period CCL minutes per line

g = annual growth rate of CCL minutes per line

Case 1: Per Line Productivity

In this case, we assume that costs per line change with the inflation-adjusted productivity measure (GNP-PI - X). The CCL is then computed by dividing the cost per line by the CCL minutes per line:

CCL_{base}: C/M

$CCL_{proposed}$: [C(1 + GNP-PI - X)]/[M(1 + g)],

since costs per line increase by "GNP-PI - X" and minutes increase by "g".

To determine the productivity change:

$$(CCL_{proposed} - CCL_{base})/CCL_{base} = ((1 + GNP\text{-}PI - X)/(1 + g)) - 1$$

$$= (GNP\text{-}PI - X - g)/(1 + g)$$

Case 2: Per Minute Productivity

In this case, we assume that the CCL rate (costs per minute) changes with the inflation-adjusted productivity measure (GNP-PI - X).

CCL_{base} : C/M

$CCL_{proposed}$: (1 + GNP-PI - X)(C/M)

$(CCL_{proposed} - CCL_{base})/CCL_{base} = (1 + GNP\text{-}PI - X) - 1$

$= (GNP\text{-}PI - X)$

Case 3: Simple Average of Per Line and Per Minute Productivity Formulas

$Average = (1/2)(GNP\text{-}PI - X) + (1/2)(GNP\text{-}PI - X - g)/(1 + g)$

$= [(GNP\text{-}PI - X) + (g/2)(GNP\text{-}PI - X - 1)]/(1 + g)$

March 16, 1989

Statement of
Chairman Dennis R. Patrick
on the
Adoption of Incentive Regulation

For the past two years, the FCC has been examining the possible implementation of incentive, or price cap, regulation for dominant interstate carriers. Today, we take the first step by adopting a plan for AT&T. This decision will save consumers approximately $900 million during the next four years in interstate long-distance rates charged by AT&T. $700 million of those savings will go to residential customers and $200 million will go to business customers.

These benefits come by reversing the incentives created by our regulatory system. The rate-of-return regulation system we use today is cost-plus contracting, pure and simple. We tell carriers they can charge rates that will cover their costs and earn about 12% on every dollar invested. We therefore create for the telecommunications industry all the perverse incentives associated with cost-plus contracting. Under rate-of-return regulation, carriers have incentives:

- to pad the rate base and operate inefficiently, since costs are recovered in their rates.
- to be less efficient and innovative, since we take away all resulting profits that exceed a defined return.
- to improperly cross-subsidize by shifting costs from more competitive services to less competitive services, since such cost-shifting allows price increases in less competitive services.

In the end, ratepayers pay for this padding, lost efficiency, and cost-shifting. Having helped create these perverse incentives, we then spend millions each year attempting to prevent carriers from acting in accordance with them. Of course, it is impossible to second-guess the investment decisions of every carrier in the industry every year, or to detect and correct every foregone efficiency.

Price cap regulation replaces these perverse incentives with pro-consumer, efficiency-enhancing incentives. We replace cost-plus regulation with price regulation. We give carriers a price ceiling -- an aggressive mark that will ensure consumers share in the benefits upfront, whether or not carriers actually succeed in improving their productivity. But, if carriers can beat the mark and improve their historical productivity

levels by more than 20%,[1] they can keep some increased profits in the short run.

Thus, this is not a zero sum game -- even in the short term, both the companies and consumers are better off.

In the long term, prices can be reduced even more dramatically as the carriers improve their efficiency. When the Commission conducts its comprehensive performance review after the third year, we will be able to adjust prices or the productivity factor to capture additional benefits for consumers from the new efficiencies created by incentive regulation. These long-term benefits in the telecommunications industry will ripple throughout the economy as more and more sectors take advantage of cheaper and better telecommunications services. The long-term benefits to consumers and industry are incalculable.

The process by which the Commission has conducted its evaluation of alternatives to rate base, rate of return regulation has been unprecedented in its depth, its scope, and in terms of public participation. We have issued two detailed Notices of Proposed Rulemaking, received and reviewed more than 10,000 pages of comments from interested parties, and discussed price cap issues in detail in five congressional hearings. I believe that the Commission and the public have benefited from this extensive, public discussion of the issues by the Commission, interested parties, and Members of Congress on both sides of the aisle.

The resulting plan will benefit consumers and fulfil my pledge not to vote for a price cap plan unless consumers were better off than under continued rate-of-return regulation. I also believe that we are taking all the steps necessary to ensure that important public policy concerns are advanced by our price cap plan --

- Residential consumers will be benefited by price cap regulation. Apart from any exogenous cost changes, which will be flowed through to consumers, the average residential long-distance rate will decrease each year by at least 2% in real terms.

- Geographically averaged rates are in no way jeopardized by a change to incentive regulation.

---

1 Historically, AT&T and the LECs have experienced productivity gains 2.5% greater than the gains experienced by the U.S. economy as a whole. To increase profits under our price cap plan, they will have to increase their productivity to more than 3.0%, or more than 20% higher than the historic average.

- The Unity 1A safeguards adopted by the Commission two years ago to preserve universal service and support high-cost telephone companies will be maintained in their entirety.

- The competitive process in the long-distance market will be protected through the maintenance of a 5% lower band for purposes of permitting streamlined tariff review.

But the Commission's job is not yet complete. The $900 million in consumer benefits results from application of incentive regulation to AT&T alone. Approximately half the costs of interstate phone calls are the costs of the access provided by local telephone companies. This order seeks further comment on specific revisions to the current price cap proposal for these companies -- revisions that appear to be necessary because of possible variations in individual LEC productivity around the industry average. I think there is a particularly strong basis for applying incentive regulation to these companies since they are, in general, less subject to the discipline of competition than AT&T. Implementation of incentive regulation for the local telephone companies' provision of interstate access should provide significant additional benefits to American consumers.

Statement of

Commissioner James H. Quello

In re: Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No. 87-313 (Price Caps)

I believe that this action is in the public interest and long overdue. The Commission, after exhaustive inquiry and comprehensive analysis, has taken a first step in imposing a new form of regulation upon AT&T, the sole interexchange carrier still considered dominant. While initiating an incentive scheme of regulation for AT&T, I believe we could have reasonably gone farther to enhance competition and benefit the public.

I am not convinced that we needed to impose floors limiting AT&T's flexibility to lower its prices. After all, we should not be in a position of limiting public benefits which result from falling prices. Nor should we be handicapping AT&T's ability to compete in markets in which there is intense and growing competition.

I am reluctantly supporting the imposition of floors at this time out of an abundance of caution and in the spirit of collegial compromise. I hope and expect that it will soon become apparent that such restraint is unnecessary and counterproductive.

With respect to the Further Notice of Proposed Rulemaking considering the imposition of price caps for the local exchange carriers, I continue to favor a structure which will provide some significant, tangible consumer benefit from the start. I would welcome a manifestation of good faith from the local exchange carriers in the form of rate reductions in the initial price cap tariff filings. While I am not wedded to any particular structure for this rate reduction, I do expect a sincere effort on the part of the carriers to bring something to the table. The timetable for implementation of price caps for the local exchange carriers presupposes that we will have rules in place well in advance of July 1, 1990. It will require the best efforts of the carriers and the Commission to ensure that those rules can be written in a timely fashion.

Again, I believe that incentive regulation holds the promise of benefiting ratepayers and shareholders alike. The care we take in implementing such regulation is crucial in realizing that promise.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554 DA 89-455

In the Matter of	)	
	)	
Policy and Rules Concerning Rates for Dominant Carriers	)	CC Docket No. 87-313
	)	
	)	

ERRATUM

Released: April 24, 1989

1. On April 17, 1989, this Commission released a Report and Order and Second Further Notice of Proposed Rulemaking in the above referenced docket adopting final rules implementing price cap regulation for American Telephone and Telegraph Company (AT&T), and proposing rules to implement price cap regulation for local exchange carriers (LECs).[1] That Report and Order and Second Further Notice should be corrected in the manner described in the following paragraphs.

2. In the first sentence of paragraph 660, the reference should be to Section 64.901 of this Commission's Rules, rather than to Section 94.901. Paragraph 660 is accordingly corrected to reflect this reference to Section 64.901 of this Commission's Rules, 47 C.F.R. § 64.901.

3. In paragraph 906, this Commission adopted final rules for AT&T, but failed explicitly to establish an effective date for those rules. Accordingly, the ordering clauses of the Report and Order and Second Further Notice of Proposed Rulemaking are corrected by adding a new paragraph 914 to read as follows:

> **914.** IT IS FURTHER ORDERED that pursuant to Section 1.427(b) of this Commission's Rules, 47 C.F.R. § 1.427(b), the rules amendments adopted in paragraph 913, supra, shall be effective on May 17, 1989. Good cause exists to make these rules amendments effective less than 30 days from publication in the FEDERAL REGISTER, in that we wish to begin obtaining the public benefits of price cap regulation enumerated supra with tariff filings to become effective on July 1, 1989, on not

---

1 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, FCC 89-91, released Apr. 17, 1989.

less than 45 days' notice. In order to accommodate this schedule, AT&T must file its initial price cap tariffs pursuant to the rules amendments adopted herein on or before May 17, 1989. As of May 17, 1989, the public will have had 30 days' actual notice of the rules amendments adopted herein, beginning with the release of this Report and Order and Second Further Notice of Proposed Rulemaking.

4. In paragraph 913, the due date for initial comments on the proposed price cap rules for LECs should be June 19, 1989, rather than June 17, 1989. Paragraph 913 is accordingly corrected to reflect a due date of June 19, 1989, for initial comments.

5. In Section 61.44(f) of the final rules adopted for AT&T, set out on page 10 of Appendix B of the Report and Order and Second Further Notice of Proposed Rulemaking, the reference should be to "w(GNP-PI - X)", rather than to "w(GNP-PI - X)/100". Appendix B is accordingly corrected to reflect this reference to "w(GNP-PI - X)".

6. In Section 61.45(b) of the proposed rules for LECs, set out on page 5 of Appendix D of the Report and Order and Second Further Notice of Proposed Rulemaking, the price cap index formula should read "$PCI_t = PCI_{t-1}[1 + (GNP\text{-}PI - X) + \Delta Y/R + \Delta Z/R]$," rather than "$PCI_t = PCI_{t-1}[1 + (GNP\text{-}PI - X) + \Delta Z/R]$." Accordingly, Appendix D is corrected to reflect the price cap index formula stated above.

7. In Section 61.45(e) of the proposed rules for LECs, set out on page 7 of Appendix D of the Report and Order and Second Further Notice of Proposed Rulemaking, the reference should be to "w(GNP-PI - X)", rather than to "w(GNP-PI - X)/100". Appendix D is accordingly corrected to reflect this reference to "w(GNP-PI - X)".

FEDERAL COMMUNICATIONS COMMISSION

Donna R. Searcy
Secretary

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

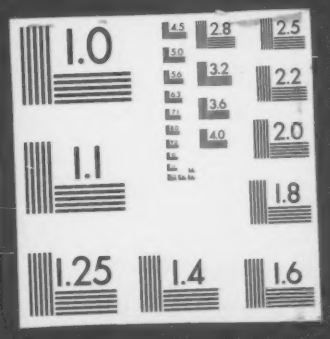
In the Matter of	)	
	)	
	)	Transmittal No. 74
Ameritech Operating Companies	)	
	)	
Revisions to Tariff F.C.C. No. 2	)	

CORRECTION

The Memorandum Opinion and Order, FCC 89-97, released April 25, 1989, concerning the above-captioned proceeding is cited in the FCC Record, 7 FCC Rcd 2699. This document corrects the release date from April 5, 1989 to April 25, 1989.

Federal Communications Commission

☆ U.S. GOVERNMENT PRINTING OFFICE: 1989—242 -518 /00016


1.0
1.1
1.25
1.4
1.6
1.8
2.0
2.2
2.5
2.8
3.2
3.6
4.0
4.5
5.0
5.6
6.3
7.1
8.0
9.0